NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents (ANSI PH5.9-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.

CIS

Congressional Information Service, Inc
Washington, D.C.

REGULATORY REFORM OF THE OIL PIPELINE INDUSTRY

(98-30)

HEARINGS

BEFORE THE
SUBCOMMITTEE ON SURFACE TRANSPORTATION
OF THE
COMMITTEE ON
PUBLIC WORKS AND TRANSPORTATION
HOUSE OF REPRESENTATIVES
NINETY-EIGHTH CONGRESS
FIRST SESSION
ON

H.R. 2677

TO AMEND THE INTERSTATE COMMERCE ACT TO REFORM AND IMPROVE REGULATION OF THE TRANSPORTATION OF OIL BY PIPELINE, AND FOR OTHER PURPOSES

NOVEMBER 9 AND 10, 1983

Printed for the use of the
Committee on Public Works and Transportation

U.S. GOVERNMENT PRINTING OFFICE
30-777 O WASHINGTON : 1984

HG41-11

COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION

JAMES J. HOWARD, New Jersey, *Chairman*

GLENN M. ANDERSON, California
ROBERT A. ROE, New Jersey
JOHN B. BREAUX, Louisiana
NORMAN Y. MINETA, California
ELLIOTT H. LEVITAS, Georgia
JAMES L. OBERSTAR, Minnesota
HENRY J. NOWAK, New York
ROBERT W. EDGAR, Pennsylvania
ROBERT A. YOUNG, Missouri
NICK JOE RAHALL II, West Virginia
DOUGLAS APPLEGATE, Ohio
GERALDINE A. FERRARO, New York
BRIAN J. DONNELLY, Massachusetts
DONALD JOSEPH ALBOSTA, Michigan
RON de LUGO, Virgin Islands
GUS SAVAGE, Illinois
FOFO I. F. SUNIA, American Samoa
KATIE HALL, Indiana
DOUGLAS H. BOSCO, California
JAMES F. McNULTY, Jr., Arizona
JIM MOODY, Wisconsin
ROBERT A. BORSKI, Pennsylvania
JOE KOLTER, Pennsylvania
TIM VALENTINE, North Carolina
EDOLPHUS TOWNS, New York
WILLIAM O. LIPINSKI, Illinois
MICHAEL A. ANDREWS, Texas
TOM J. VANDERGRIFF, Texas
J. ROY ROWLAND, Georgia
JAMES McCLURE CLARKE, North Carolina
ROBERT E. WISE, Jr., West Virginia

GENE SNYDER, Kentucky
JOHN PAUL HAMMERSCHMIDT, Arkansas
BUD SHUSTER, Pennsylvania
ARLAN STANGELAND, Minnesota
NEWT GINGRICH, Georgia
WILLIAM F. CLINGER, Jr., Pennsylvania
GUY MOLINARI, New York
E. CLAY SHAW, Jr., Florida
BOB McEWEN, Ohio
FRANK WOLF, Virginia
THOMAS E. PETRI, Wisconsin
HAL DAUB, Nebraska
LYNN MARTIN, Illinois
VIN WEBER, Minnesota
ROBERT F. (BOB) SMITH, Oregon
DON SUNDQUIST, Tennessee
NANCY L. JOHNSON, Connecticut
RON PACKARD, California

Subcommittee on Surface Transportation

GLENN M. ANDERSON, California, *Chairman*

ROBERT W. EDGAR, Pennsylvania
NICK JOE RAHALL II, West Virginia
BRIAN J. DONNELLY, Massachusetts
GUS SAVAGE, Illinois
FOFO I. F. SUNIA, American Samoa
JAMES F. McNULTY, Jr., Arizona
JIM MOODY, Wisconsin
WILLIAM O. LIPINSKI, Illinois
MICHAEL A. ANDREWS, Texas
TOM J. VANDERGRIFF, Texas
JOHN B. BREAUX, Louisiana
NORMAN Y. MINETA, California
DOUGLAS APPLEGATE, Ohio
DONALD JOSEPH ALBOSTA, Michigan
DOUGLAS H. BOSCO, California
ROBERT A. BORSKI, Pennsylvania
JOE KOLTER, Pennsylvania
RON de LUGO, Virgin Islands
JAMES J. HOWARD, New Jersey
(Ex Officio)

BUD SHUSTER, Pennsylvania
JOHN PAUL HAMMERSCHMIDT, Arkansas
NEWT GINGRICH, Georgia
WILLIAM F. CLINGER, Jr., Pennsylvania
E. CLAY SHAW, Jr., Florida
FRANK WOLF, Virginia
HAL DAUB, Nebraska
LYNN MARTIN, Illinois
ROBERT F. (BOB) SMITH, Oregon
GENE SNYDER, Kentucky
(Ex Officio)

CONTENTS

Proceedings of: Page
November 9, 1983 1
November 10, 1983 301
H.R. 2677: To amend the Interstate Commerce Act to reform and improve regulation of the transportation of oil by pipeline, and for other purposes v

TESTIMONY

Barber, Richard J., economic consultant, Trans Alaska Pipeline 428
Baxter, William F., Assistant Attorney General, Antitrust Division, Department of Justice, accompanied by David W. Brown, Assistant Chief, Energy Section, Antitrust Division, Department of Justice 119
Bedell, Hon. Berkley, a Representative in Congress from the State of Iowa 326
Blum, Jack A., on behalf of the Independent Gasoline Marketers Council 370
DeMuth, Hon. Christopher C., Administrator for Information and Regulatory Affairs, Office of Management and Budget 131
Fountain, Kenneth P., general counsel, Exxon Pipeline Co 428
Hunter, Thomas, director, Crude Supply and Planning, Farmland Industries, accompanied by Joe Crites, assistant counsel, Farmland Industries 335
Love, James, Center for Study of Responsive Law 352
Mampe, Edwin P., Jr., director, government affairs, Crown Central Petroleum Corp 360
Mares, Jan W., Assistant Secretary for Fossil Energy, U.S. Department of Energy, accompanied by Leonard Coburn, Director, Office of Competition, Department of Energy 143
Maynard, Robert, assistant attorney general, State of Alaska, accompanied by Mark Wittow, associate director for natural resources and transportation, Governor's office, State of Alaska 164
Means, Dr. Robert C., Director, Office of Regulatory Analysis, Federal Energy Regulatory Commission, accompanied by Lynne H. Church, Associate General Counsel, Federal Energy Regulatory Commission 91
Merriman, Donald R., president, Buckeye Pipe Line Co., on behalf of Association of Oil Pipe Lines, accompanied by Pat Corcoran, executive director, and counsel to the Association of Oil Pipe Lines, (AOPL); and Edward J. Mitchell, professor of business economics, University of Michigan 265
Van Arsdall, R. Thomas, vice president, agricultural inputs and services, National Council of Farmer Cooperatives 345

SUBMISSIONS FOR THE RECORD

Barber, Richard J., president, Richard J. Barber Associates, Inc.:
Statement 374
"The Transportation of Alaskan North Slope Oil by Pipeline: An Assessment of the Competitive Issues Relevant to Rate Deregulation," November 1983 376
Baxter, William F., Assistant Attorney General, Antitrust Division, Department of Justice, statement 107
Bedell, Hon. Berkley, a Representative in Congress from the State of Iowa, statement 302
Blum, Jack A., on behalf of the Independent Gasoline Marketers Council, statement 367
Breaux, Hon. John, a Representative in Congress from the State of Louisiana, statement 3

Page

Corcoran, Patrick H., executive director, Association of Oil Pipelines "Critique of 1983 Study on Oil Pipeline Regulation" by James Love, Center for the Study of Responsive Law 272
DeMuth, Christopher C., Administrator for Information and Regulatory Affairs, Office of Management and Budget:
  Statement 129
  The Effect of Oil Pipeline Deregulation on Federal Revenues 135
Fountain, Kenneth P., officer and director, Exxon Pipeline Co.:
  Statement 426
  Letter to Representative Berkley Bedell, dated November 3, 1983 433
  Letter to Representative Berkley Bedell, from A. G. Sousa, Acting Chairman, Federal Energy Regulatory Commission, dated November 9, 1983 437
Hunter, Thomas, director, crude supply and planning, Farmland Industries, statement 332
Love, James, Center for Study of Responsive Law, statement 350
Mampe, Edwin P., Jr., director, government affairs, Crown Central Petroleum Corp.:
  Statement 358
  Map "Product Pipelines" 361
Mares, Jan W., Assistant Secretary for Fossil Energy, U.S. Department of Energy, statement 141
Maynard, Robert, assistant attorney general, State of Alaska:
  Position paper of the State of Alaska 151
  Letter from Norman C. Gorsuch, attorney General, State of Alaska, to Representative Anderson, dated November 7, 1983 160
  Chart on Projected Trans-Alaska Pipeline System (TAPS) 162
Means, Robert C., Director, Office of Regulatory Analysis, Federal Energy Regulatory Commission:
  Statement 7
  Fact Sheet: U.S. Oil Pipeline Industry, FERC, December 1982 90
Merriman, Donald R., president, Buckeye Pipe Line Co., on behalf of the Association of Oil Pipe Lines:
  Statement 172
  Analysis of bill 183
  Letter supplementing testimony 291
Mitchell, Edward J., professor of business economics, University of Michigan, on behalf of the Association of Oil Pipe Lines:
  Statement 185
  "The NERA Study of Competition in Oil Pipeline Markets: A Critique," October 1983 199
Murkowski, Hon. Frank H., a U.S. Senator from the State of Alaska, statement 149
Van Arsdall, R. Thomas, vice president, agricultural inputs and services, National Council of Farmers Cooperatives:
  Statement 343
  Letter supplementing testimony 349

ADDITIONS TO THE RECORD

The Heritage Foundation, Virginia E. Gilbert, director, legislative information, March 1, 1983 Backgrounder "National Gas Deregulation, Giving the Consumer a Choice" 453
Turpin, F. G., president, Alyeska Pipeline Service Co., statement 464

98TH CONGRESS
1ST SESSION

H. R. 2677

To amend the Interstate Commerce Act to reform and improve regulation of the transportation of oil by pipeline, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

APRIL 21, 1983

Mr. BREAUX (for himself, Mr. ANDERSON, Mr. SHUSTER, Mr. FIELDS, Mr. GRAMM, Mr. WILSON, AND MR. TAUZIN) introduced the following bill; which was referred jointly to the Committees on Energy and Commerce and Public Works and Transportation

---

A BILL

To amend the Interstate Commerce Act to reform and improve regulation of the transportation of oil by pipeline, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Oil Pipeline Regulatory Reform Act of 1983".

SEC. 2. It is the purpose of this Act—

(1) to foster a competitive oil pipeline industry and assure service on an equal basis without unjust discrimination;

(2) to induce the investment in new oil pipeline construction and expansion necessary to achieve maximum productivity; and

(3) to encourage the elimination of unnecessary regulation.

SEC. 3. (a) Section 306 of the Department of Energy Organization Act (42 U.S.C. 7155) is repealed.

(b) Section 402(b) of the Department of Energy Organization Act (42 U.S.C. 7172(b)) is repealed.

(c) Section 402 of the Department of Energy Organization Act (42 U.S.C. 7172) is amended by adding at the end thereof the following:

"(i) Except to the extent that functions and authority are no longer in effect as a result of the amendments made by section 4 of the Oil Pipeline Regulatory Reform Act of 1983, there are hereby transferred to, and vested in, the Commission such functions which were transferred to the Secretary under section 306 of this Act (as section 306 existed on the day before the date of enactment of this subsection) and there are vested in the Commission such functions and authority which were transferred to, and vested in, the Commission under subsection (b) of this section (as subsection (b) existed on the day before the date of enactment of this subsection).".

SEC. 4. (a) Except as otherwise expressly provided in this section, whenever in this section an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be a reference to a section or other provision of the Interstate Commerce Act.

(b) Paragraph (4) of section 1 (49 U.S.C. 1(4)) is amended to read as follows:

"(4) It shall be the duty of every common carrier subject to this part to provide and furnish transportation upon reasonable request therefor, and to establish reasonable through routes with other such carriers. It shall be the duty of every such common carrier establishing through routes to provide reasonable facilities for operating such routes and to make reasonable rules and regulations with respect to their operation.".

(c) Paragraph (5)(a) of section 1 (49 U.S.C. 1(5)(a)) is repealed.

(d) Paragraph (4) of section 13 (49 U.S.C. 13(4)) is amended to read as follows:

"(4) Whenever in any such investigation the Commission, after full hearing, finds that any such rate, charge, regulation, or practice causes any undue or unreasonable advantage, preference, or prejudice as between persons or localities in intrastate commerce on the one hand and interstate or foreign commerce on the other hand, or any undue, unreasonable, or unjust discrimination against, or undue burden on, interstate or foreign commerce (which the Commission may find without a separation of interstate and intrastate property, revenues, and expenses, and without considering in totality the operations or results thereof of any carrier, or group or groups of carriers wholly within any State), which is hereby forbidden and declared to be unlawful, it shall (a) set aside such rate, charge, regulation, or practice, and (b) in the case of a regulation or practice shall prescribe the regulation or practice thereafter to be observed, in such manner as, in its judgment, will remove such advantage, preference, prejudice, discrimination, or burden. Such regulations and practices shall be observed while in effect by the carriers parties to such proceeding affected thereby, the law of any State or decision or order of any State authority to the contrary notwithstanding.".

(e) Paragraph (1) of section 15 (49 U.S.C. 15(1)) is amended to read as follows:

"(1) Whenever, after full hearing, upon a complaint made as provided in section 13 of this part, or after full hearing under an order for investigation and hearing made by the Commission on its own initiative, either in extension of any pending complaint or without any complaint whatever, the Commission shall be of opinion that—

"(a) any individual or joint rate or charge whatsoever demanded, charged, or collected by any common carrier or carriers subject to this part for the transportation of oil is or will be unjustly discriminatory or unduly preferential or prejudicial under the provisions of this part; or

"(b) any individual or joint regulation, or practice whatsoever of such carrier or carriers subject to the provisions of this part, is or will be unjust or unreasonable or unjustly discriminatory or unduly preferential or prejudicial, or otherwise in violation of any of the provisions of this part;

the Commission is authorized and empowered to make an order that the carrier or carriers shall cease and desist from such violation to the extent to which the Commission finds that the same does or will exist and in the case of a regulation or practice to determine and prescribe what individual or joint regulation, or practice is or will be just, fair, and reasonable, to be thereafter followed, and to make an order that the carrier or carriers shall conform to and observe the regulation or practice so prescribed.".

(f) Paragraph (3) of section 15 (49 U.S.C. 15(3)) is amended to read as follows:

"(3) The Commission may, and it shall whenever deemed by it to be necessary or desirable in the public interest, after full hearing upon complaint or upon its own initiative without complaint, establish through routes applicable to transportation by carriers subject to this part and the terms and conditions under which such through routes shall be operated. If any tariff or schedule canceling any through route without the consent of all carriers parties thereto or authorization by the Commission, is suspended by the Commission for investigation, the burden of proof shall be upon the carrier or carriers proposing such cancellation to show that it is consistent with the public interest, without regard to the provisions of paragraph (4) of this section.".

(g) Paragraph (6) of section 15 (49 U.S.C. 15(6)) is repealed.

(h) Paragraph (7) of section 15 (49 U.S.C. 15(7)) is amended to read as follows:

"(7) Whenever there shall be filed with the Commission any schedule stating a new individual or joint rate or charge, or any new individual or joint regulation or practice affecting any rate or charge, the Commission shall have, and it is given, authority, either upon complaint or upon its own initiative without complaint, at once, and if it so orders without answer or other formal pleading by the interested carrier or carriers, but upon reasonable notice, to enter upon a hearing concerning whether such rate or charge is unjustly discriminatory or unduly preferential or prejudicial or concerning the lawfulness of such regulation or practice; and pending a hearing concerning the lawfulness of a regulation or practice and the decision thereon the Commission, upon delivering to the carrier or carriers affected thereby a statement in writing of its reasons for such suspension, may from time to time suspend the operation of such regulation or practice and defer the use of such regulation or practice, but not for a longer period than seven months beyond the time when it would otherwise go into effect; and after full hearing, whether completed before or after the regulation or practice goes into effect, the Commission may make such order with respect to any new rate or charge, or new regulation or practice as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made within the period of suspension, the proposed change of regulation or practice shall go into effect at the end of such period. At any hearing involving a change in a rate or charge, or in a rule, regulation, or practice, the burden of proof shall be upon the complainant to show that the proposed changed rate or charge is unjustly discriminatory or unduly preferential or prejudicial or that the proposed rule, regulation, or practice is not just and reasonable, and the Commission shall give to the hearing and decision of such questions preference over all other questions pending before it and decide the same as speedily as possible.".

(i) Section 3 of the Act of December 12, 1945 (49 U.S.C. 65a), is repealed.

Sec. 5. No State or political subdivision thereof, and no interstate agency or other political agency of two or more States, shall review, prescribe, suspend, set aside, or in any manner regulate the rates or charges of any common carrier for transportation of oil by pipeline in interstate commerce or the regulations and practices pertaining to such transportation.

Sec. 6. This Act, and the amendments made by this Act, shall take effect sixty days after the date of enactment of this Act.

REGULATORY REFORM OF THE OIL PIPELINE INDUSTRY

WEDNESDAY, NOVEMBER 9, 1983

House of Representatives,
Subcommittee on Surface Transportation,
Committee on Public Works and Transportation,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:22 a.m., in room 2167 Rayburn House Office Building, Hon. Glenn M. Anderson (chairman of the subcommittee) presiding.

Mr. Anderson. The meeting of the subcommittee will come to order.

This morning the Subcommittee begins two days of hearings on H.R. 2677, the Oil Pipeline Regulatory Reform Act of 1983. When this legislation was introduced by my good friend and colleague from Louisiana, Mr. Breaux, I agreed to add my name as a cosponsor. And I said at that time I was doing so largely to help him focus attention on his legislation.

From the response we received to the meeting notice announcing these hearings, that attention has now been focused. In the same vein, it is important that this subcommittee receive testimony from those parties most interested in this legislation. Frankly, this is not an issue which the subcommittee has addressed up to now, and as such, it is one on which we have much to learn.

It is apparent that this is a most complex issue. And I doubt whether even 2 days of hearings will give us sufficient time to thoroughly examine the regulatory environment surrounding the oil pipeline industry or the ways in which that environment will be altered by the legislation which is before us.

But, because our committee does have jurisdiction over this legislation, and because other committees in the House and Senate which share this jurisdiction may be advancing proposals of their own during the second session of the 98th Congress, it would be irresponsible if we did not endeavor to learn all we can about the industry and this proposal.

This learning process will not conclude with the close of hearings tomorrow afternoon. It will be a continuous process, and one which will require greater input from our witnesses and others from the public who are interested in the regulatory reform of the oil pipeline industry.

Mr. Daub, do you have an opening statement?

Mr. Daub. No, thank you.

Mr. ANDERSON. Mr. Breaux, the author of the bill, H.R. 2677, has been detained, and will join us soon. I will place in the record at this point, his opening statement.

[Statement referred to follows:]

STATEMENT OF
REP. JOHN BREAUX
BEFORE THE
SUBCOMMITTEE ON
SURFACE TRANSPORTATION
ON H.R. 2677
NOVEMBER 9, 1983

MR. CHAIRMAN, THANK YOU AND THE SUBCOMMITTEE FOR HOLDING THESE HEARINGS ON H.R. 2677, THE PROPOSED "OIL PIPELINE REGULATORY REFORM ACT OF 1983." THE BILL PROPOSES SOME REFORM AND MODIFICATION OF THE WAY THE GOVERNMENT REGULATES OIL PIPELINE TRANSPORTATION RATES. THE LEGISLATIVE EMPHASIS IS ON REGULATORY REFORM.

THE OIL PIPELINE INDUSTRY IS REGULATED TODAY AS A RESULT OF CONGRESSIONAL AMENDMENTS TO THE HEPBURN ACT OF 1906, WHICH AMENDED THE INTERSTATE COMMERCE ACT. NOW, THREE-QUARTERS OF A CENTURY LATER, IT IS TIME FOR THE CONGRESS TO REVIEW THOROUGHLY THE STATUTORY AND REGULATORY REGIME WHICH GOVERNS THE INDUSTRY, CHANGE SOME PROVISIONS AND RETAIN OTHERS. THE BILL PROPOSES A MORE BALANCED APPROACH OF CONTINUED GOVERNMENT REGULATION AND MARKETPLACE COMPETITION.

H.R. 2677 IS A STARTING POINT IN THE PROPOSED REVIEW AND AMENDMENT PROCESS. IT IS A BEGINNING. IT IS CRITICAL, THOUGH, THAT CONGRESSIONAL ACTIVITY COMMENCE ON THE BILL, AS WE ARE DOING TODAY WITH THESE HEARINGS, AND CONTINUE TO PURSUE IT IN A TIMELY MANNER.

LEGISLATIVELY, THE BILL PROPOSES TO REPEAL FERC'S AUTHORITY TO SUSPEND RATES, EXCEPT IN THE CASE OF DISCRIMINATORY PRACTICES, IN WHICH CASES SHIPPER COMPLAINTS AND FERC ITSELF MAY INITIATE GOVERNMENT ACTION. ALSO, THE BILL WOULD REPEAL FERC'S AUTHORITY TO SET TRANSPORTATION RATES. FERC'S AUTHORITY TO PROTECT AGAINST DISCRIMINATORY PRACTICES IS RETAINED AND THE JUSTICE DEPARTMENT'S AUTHORITY TO IMPLEMENT ANTITRUST SAFEGUARDS REMAIN. OIL PIPELINES

WOULD REMAIN COMMON CARRIERS, AS THEY ARE UNDER THE LAW TODAY.

ADEQUATE INTERMODAL AND INTRAMODAL COMPETITION EXISTS TODAY IN THE OIL TRANSPORTATION INDUSTRY. OIL PIPELINES COMPETE AMONGST THEMSELVES FOR CRUDE AND PRODUCT BUSINESS. WATER CARRIERS, WHICH ARE UNREGULATED AS TO TRANSPORTATION RATES, COMPETE WITH PIPELINES. TRUCKS AND RAIL ALSO COMPETE BUT IN A MUCH MORE LIMITED MANNER.

INDUSTRY FIGURES, BASED ON GOVERNMENT AND INDUSTRY DATA, SHOW WATER CARRIERS TRANSPORTING JUST OVER 50 PERCENT OF THE CRUDE AND PETROLEUM PRODUCTS IN 1981, THE DATE FOR WHICH THE LATEST DATA IS AVAILABLE. OIL PIPELINES CARRIED JUST OVER 46 PERCENT OF CRUDE AND PETROLEUM PRODUCT IN 1981. THE OIL PIPELINE MARKET SHARE REPRESENTED A SMALL DECLINE FROM THE PREVIOUS YEAR, WITH WATER CARRIERS INCREASING THEIR MARKET SHARE BY A SIMILAR SMALL AMOUNT OVER 1980. TRUCKS AND RAIL REPRESENTED, TOGETHER, ABOUT THREE PERCENT OF THAT TRAFFIC, WHICH WAS A SMALL DECLINE FROM 1980.

OTHER FACTORS CONTRIBUTE TO THIS NEED FOR OIL PIPELINE RATE REGULATORY REFORM. THE INDUSTRY ITSELF HAS UNDERGONE CONSIDERABLE CHANGE. TODAY, THERE ARE AN ESTIMATED 227,000 MILES OF OIL PIPELINE IN THE UNITED STATES REGULATED BY EITHER FEDERAL OR STATE LAWS. OVER 130 OIL PIPELINE COMPANIES ARE INVOLVED IN INTERSTATE COMMERCE AND REGULATED BY THE FEDERAL GOVERNMENT. ENTRY AND EXIT INTO THE OIL PIPELINE BUSINESS IS OPEN. OIL PIPELINES CARRY ABOUT 23 PERCENT OF INTERCITY FREIGHT, WHICH REPRESENTS ABOUT THREE PERCENT OF INTERCITY FREIGHT REVENUE. CAPITAL INVESTMENT IS INTENSIVE, ABOUT $21.0 BILLION.

CONSUMER IMPACT OF OIL PIPELINE TRANSPORTATION RATES, AS ESTIMATED BY FERC, COMPRISE APPROXIMATELY 1.5 CENTS OF THE PUMP PRICE FOR GASOLINE, BASED ON TRANSPORTATION RATES IN THE LOWER 48 STATES.

CHANGES IN THE GOVERNMENT'S ROLE IN OIL PIPELINE RATE REGUTION OVER THE PAST YEAR AFFORD ANOTHER OPPORTUNITY TO REVIEW THE NEED FOR CONTINUED CONTROLS. THE ACTION TAKEN BY FERC IN THE WILLIAMS PIPELINE COMPANY RATE CASE, PENDING BEFORE A FEDERAL APPEALS COURT AND TIED UP IN THE COURTS AND FEDERAL AGENCIES FOR OVER TEN YEARS, AND THE VACATING OF THE GOVERNMENT'S FORTY-YEAR OLD CONSENT DECREE WITH CERTAIN OIL PIPELINE SUBSIDIARIES AND THEIR PARENT OWNERS BY A FEDERAL COURT, ARE PRIME EXAMPLES OF THE NEED TO QUESTION CURRENT OIL PIPELINE RATE REGULATORY AUTHORITIES. IMPORTANT TO NOTE IS FERC'S RECOMMENDATION IN THE WILLIAMS CASE THAT THE CONGRESS REVIEW THE ISSUE OF OIL PIPELINE RATE REGULATION.

OIL PIPELINES ARE THE ONLY SEGMENT OF THE OIL INDUSTRY WHICH REMAINS UNDER GOVERNMENT REGULATION. OIL PRICES WERE DECONTROLLED OVER TWO YEARS AGO. THERE IS NO NEED TO CONTINUE REGULATION OF OIL PIPELINE RATES FOR TRANSPORTATION SERVICES. IN THE 77 YEARS SINCE THE INDUSTRY FIRST WAS INCORPORATED INTO THE GOVERNMENT'S REGULATORY STRUCTURE, THE INDUSTRY HAS GROWN AND EXPANDED. IT HAS SERVED THE NATION EFFICIENTLY, ECONOMICALLY, AND COMPETITIVELY.

MR. CHAIRMAN, THERE IS NO NEED TO PROLONG UNNECESSARY GOVERNMENT REGULATION OF ANY INDUSTRY OR ENTERPRISE SIMPLY FOR REGULATION'S SAKE, WHICH IS THE CASE TODAY WITH OIL PIPELINE RATE REGULATION BY THE FEDERAL GOVERNMENT. H.R. 2677 WOULD AUTHORIZE ONLY CHANGE WHERE IT IS NEEDED AND WHERE CONTINUED REGULATION IS NOT. IT PROPOSES A MORE BALANCED APPROACH TO THE ISSUE OF FEDERAL CONTROL BY ALLOWING MARKETPLACE COMPETITION TO WORK IN CONJUNCTION WITH GOVERNMENT OVERSIGHT AND SAFEGUARDS. THE BILL TAKES THE PROPER DIRECTION FOR OIL PIPELINE RATES AND IS OFFERED IN THE SPIRIT OF REGULATORY REFORM.

THANK YOU, MR. CHAIRMAN, AND MEMBERS OF THE SUBCOMMITEE.

Mr. ANDERSON. Our first witness today is Dr. Robert Means, Director of the Office of Regulatory Analysis, and we do have Dr. Means' statement here. It will all be made a matter of the record.

[The statement referred to follows:]

STATEMENT OF
ROBERT C. MEANS
DIRECTOR, OFFICE OF REGULATORY ANALYSIS
FEDERAL ENERGY REGULATORY COMMISSION
BEFORE THE
SUBCOMMITTEE ON SURFACE TRANSPORTATION
COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION
HOUSE OF REPRESENTATIVES

November 9, 1983

I appreciate the opportunity to comment on H.R. 2677, the "Oil Pipeline Regulatory Reform Act of 1983." In my view, deregulation of oil pipelines has been and continues to be an important issue upon which Congress should focus in the near future.

At the outset, however, I want to make it clear that the opinions expressed in this testimony are mine alone and do not represent the view of the Commission or of any individual Commissioner.

The first substantive question that must be examined in considering oil pipeline deregulation is whether oil pipelines have monopoly power. This is not a question that has a simple yes or no answer. Monopoly or market power is a matter of degree. The major companies in nearly every industry in the United States may have some market power, but in the great majority of industries we have concluded -- quite rightly, I believe -that the results of even less-than-perfect competition are unlikely to be improved by government regulation. The relevant issue therefore is not whether oil pipelines have some market power -- no doubt they do -- but whether their market power is great enough to justify federal regulation.

My understanding is that the Department of Justice is taking the lead in conducting an in depth study of oil pipeline competition in the lower-48 states. This study may provide more detailed information on the monopoly question. Based on the testimony of Assistant Attorney General William Baxter last year, 1/ however, it appears that the market power of some segments of the oil pipeline industry may be great enough to justify continuing regulation of some sort. While many oil pipeline markets exhibit a sufficient degree of competition to justify deregulation, there may be "pockets" of monopoly power where complete deregulation may not be the appropriate solution. It is, however, by no means clear how many or how extensive these "pockets" of monopoly power are. I doubt that in most markets it rises to a level that would justify traditional and permanent federal rate regulation.

The possible existence of pockets of monopoly power suggests the need to consider certain measures that are not now contained in H.R. 2677. In particular, the bill provides no mechanism to retain or to reimpose even the most limited type of price regulation for situations in which it can be shown that significant

---

1/ This testimony appears in Oil Pipeline Deregulation: Hearings on H.R. 4488 and H.R. 6815 Before the Subcommittee on Fossil and Synthetic Fuels of the House Committee on Energy and Commerce, 97th Cong., 2d Sess. 7-15, 44-51 (1982); Statement of William F. Baxter before Committee on Commerce, Science and Transportation, United States Senate, Concerning S. 1626, Department of Energy Organization Act Amendments of 1981 (Sept. 29, 1982) (enclosed herewith as Attachment No. 1).

market power exists. While I firmly believe that there should be a strong presumption against price regulation, Congress should reexamine the prospect of completely foreclosing the possibility of price regulation in such instances. In this regard, one approach might be to include a provision for Commission rate regulation where an oil pipeline can be shown to possess substantial market power and where the potential for abuse of that power is significant. This type of limited, pipeline-specific rate regulation should be carefully defined and should include some mechanism for future decontrol if and when the substantial market power or potential for abuse is no longer present. In addition, the burden of proof on the existence of such market power and potential for abuse should be addressed in any such scheme of limited rate regulation. 2/

The potential existence of pockets of monopoly power leads directly to the second major substantive issue raised by oil pipeline deregulation. This concerns discrimination against shippers with respect to the rates charged or the services offered. To the extent that oil pipeline companies do not have monopoly power, these provisions are unnecessary. Discrimination, like excessive rates, is linked to the existence of monopoly power.

2/ I note that Mr. Baxter has discussed this idea generally before the House Subcommittee on Fossil and Synthetic Fuels (Hearings, at 45-46) and the Senate Committee on Commerce, Science and Transportation (Statement, at 4-5).

A company that lacks such power cannot charge excessive rates because customers will turn to its competitors. For the same reason, it cannot charge different rates to different people. Where oil pipelines do have monopoly power, on the other hand, antidiscrimination provisions alone will not adequately protect shippers, since they are not violated by an independent oil pipeline company that charges uniformly excessive rates.

The retention of these provisions may also carry unforeseeable consequences for the vertically integrated 3/ companies that constitute the larger part of the industry. Vertical integration may create incentives for discrimination. An incentive for discrimination exists even without vertical integration. An independent oil pipeline may discriminate in order to increase its profits by charging a higher rate to less price responsive shippers and a lower rate to more price responsive ones. A vertically integrated pipeline may discriminate for this same reason, but it may also do so for another reason: to improve the competitive position of its corporate affiliates in upstream and downstream markets.

But vertical integration may also affect the form of discrimination. If a pipeline is vertically integrated, even uniform rates can be discriminatory if they are excessively high. For independent shippers, excessively high rates constitute a real cost, while for affiliated shippers, high rates transfer economic rents from one corporate affiliate to

---

3/ That is, most oil pipeline companies are subsidiaries of oil companies that are also shippers on the pipeline.

another. This problem was a basis for the 1941 antitrust decree 4/ under the anti-rebate provisions of the Elkins Act. 5/ In obtaining that decree, the Antitrust Division of the Department of Justice argued that dividends paid to an affiliated shipper constituted a rebate and, therefore, violated the Elkins Act.

Recently, Justice has modified this position to argue that revenues lawfully collected under the Interstate Commerce Act may be paid as dividends to owner-shippers without violating the Elkins Act. 6/ Under the latter position, the problem of rebates, and perhaps the problem of discrimination, are not clearly distinct from the problem of excessively high rates for vertically integrated oil pipelines. Retention of the antidiscrimination provisions thus could provide the means for a general reimposition of price controls on the vertically integrated firms. Under the Antitrust Division's current interpretation of the Elkins Act, that Act's anti-rebate

---

4/ United States v. Atlantic Refining Co., Civil Action No. 14060 (D.D.C. 1941).

5/ 49 U.S.C. §§ 41-43 (1976) (repealed except for its application to oil pipelines, Pub. L. No. 95-473, § 4(c), 92 Stat. 1470 (1978) and to be recodified at 49 U.S.C. §§ 11703, 11902-03, 11915-16).

6/ United States v. Atlantic Refining Co., Civil Action No. 14060, Statement of Points and Authorities in Support of Motion of United States of America to Vacate the Final Judgment and for Other Relief, at 6, 12 (D.D.C. Nov. 16, 1981).

provision makes it illegal for vertically integrated pipelines to pay dividends in excess of a "reasonable" return. 7/ At the present, that return can be based on the FERC's general regulation of pipeline rates. 8/ But, if pipelines were freed from general rate regulation, payment of dividends to affiliated shippers could make them vulnerable to treble damage actions under the Elkins Act. Moreover, a logical extension of the Antitrust Division's argument would imply that the Interstate Commerce Act's own prohibitions against discriminatory rates could be converted into a prohibition against uniform but high rates in the case of these vertically integrated oil pipelines.

The seriousness of this problem is open to some question. It depends not only on the interpretation of the provisions concerned but also on the likelihood that the provisions will be used in this way by the Antitrust Division, by the FERC, or by private parties. What can be said at this point is that these provisions constitute an unpredictable danger that regulation through regular administrative process will simply be converted into regulation through litigation. To

---

7/ United States v. Atlantic Refining Co., Civil Action No. 14060, Statement of Points and Authorities in Support of Motion of United States of America to Vacate the Final Judgment and for Other Relief, at 6 (D.D.C. 1981).

8/ See generally, Williams Pipe Line Co., 21 FERC ¶ 61,260 (Nov. 30, 1982).

avoid this danger, the Committee may wish to consider clarifying the meaning of the provisions in question, so that they are not violated by uniform high prices or by dividends paid to corporate affiliates. To the extent that high prices or excessive dividends are viewed as a serious problem, H.R. 2677 should deal with the problem directly through continued price regulation in a few markets rather than indirectly through an industry-wide prohibition against discriminatory prices and rebates.

Finally, I have one other general observation on H.R. 2677. Section 4 of the bill amends a number of sections in Title I of the Interstate Commerce Act. Ostensibly, these amendments are designed merely to remove all references to federal regulation over rates or charges. However, the amendments also make other, apparently unrelated, changes to the language of these sections. These latter changes may have the effect of unnecessarily undermining the commonly accepted statutory interpretation of Title I of the ICA. This Commission would be charged with the responsibility of enforcing these amended provisions. I believe that the Commission should be able to build on settled case law and statutory interpretations rather than having to reinterpret Title I in the light of the proposed changes to its language. The prospect of litigation and delay will not assist the Commission's enforcement efforts.

Other comments on H.R. 2677 have been drafted by the Commission staff and are enclosed (Attachment No. 2). In addition, last year Chairman Butler testified on oil pipeline deregulation before the House Subcommittee on Fossil and Synthetic Fuels during its hearings on H.R. 4488 and H.R. 6815. For your reference, his testimony and follow-up materials are enclosed (Attachment No. 3).

I hope that my comments and the analyses prepared by other Commission staff are helpful to your Committee. If I or other Commission staff can be of further assistance to you in this matter, please do not hesitate to call on us.

Attachments (3)

Department of Justice

Attachment #1

STATEMENT

OF

WILLIAM F. BAXTER
ASSISTANT ATTORNEY GENERAL
ANTITRUST DIVISION

BEFORE

COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION
UNITED STATES SENATE

CONCERNING

S. 1626
DEPARTMENT OF ENERGY
ORGANIZATION ACT AMENDMENTS OF 1981

ON

SEPTEMBER 29, 1982

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to appear before the Committee on Commerce, Science and Transportation to present the views of the Department of Justice on deregulation of the oil pipeline industry. The Administration and this Department remain committed to the careful exploration of all possible opportunities to reduce and eliminate the burden of federal regulation on private enterprise. This is the basis of our approach to the oil pipeline industry, and of our views on S. 1626, a bill that would eliminate rate regulation for domestic interstate petroleum pipelines. While we do not support the bill in its details, we do agree completely with its underlying premise that our society should rely, wherever possible, on market forces, and that regulation should be resorted to only when clearly necessary. We believe that legislation, based on this premise, can be devised that would result in complete deregulation of an overwhelming majority of the oil pipeline mileage in the lower 48 states--a result that, we believe, is desirable. I will discuss the bill in the context of our position on deregulation of this industry.

We think that in this or any industry, complete deregulation is appropriate unless it clearly appears, first, that there is a serious defect in the ability of the competitive market to ensure efficient resource allocation, and, second, that the benefits of regulation exceed its costs. In the case of regulated pipelines, the first question reduces to the issue of whether significant monopoly power exists; with the exception of a few pipeline systems, we are convinced that most of the pipeline industry is competitive. Potential cost efficiencies and economies of scale might give a few pipelines market power in certain geographic markets. Other pipelines, however, and this applies to almost all, function competitively or so nearly competitively that continued regulation is not worth the costs it imposes. Therefore, there will be substantial benefits from deregulation, and this is the strongly preferred policy.

We must always bear in mind that regulatory costs are significant. The Department's experience before the FERC in such lengthy pipeline proceedings as the TAPS and Williams Brothers Pipe Line cases gives us first-hand knowledge of some of the regulatory costs borne by this industry. The costs, moreover, are exacerbated by the uncertainty resulting from the absence of reasonable and certain regulatory standards for the pipeline industry. The regulatory history has not been satisfactory. Regulation has been overly broad, and has been applied to pipelines where it is not justified at all.

The central question for any pipeline deregulation proposal, therefore, is how to achieve deregulation while distinguishing those few pipelines that exhibit significant market power and so should not be deregulated. One approach is case-by-case deregulation, wherein the FERC would be empowered to deregulate only those pipeline systems which could demonstrate that they operate in competitive markets. Under this approach, which we strongly oppose, deregulation would be slow, burdensome and uncertain, with a great danger that regulation would continue for a time, and to an extent beyond any legitimate need. Better alternatives are available. The Department of Justice and others in the Administration are in the process of examining various alternatives to deal with those few cases. We are collecting and analyzing available transportation data on shipments and prices to assess the substantiality of intra- and inter-modal competition faced by particular pipelines. The data generally suggest that continued regulation is no longer appropriate. This situation, in turn, indicates that the preferred policy alternative is general, complete deregulation, with very limited authority for continued or renewed regulation of a few pipeline systems if, but only if, the proponents of regulation establish a very solid basis for believing that continued regulation of a particular pipeline is called for because it has significant market power. This approach preserves the virtue and benefits of immediate deregulation yet provides appropriate protection for shippers and consumers. This process would only apply to a few and limited cases and would take place quickly to reduce uncertainty in the industry.

While the precise features of our proposal are still being studied and considered by us and by others in the Administration, we are currently exploring the feasibility of a proposal with the following characteristics. It would provide for general and complete deregulation of oil pipelines on a date certain following enactment of the legislation. In an interim period between enactment and actual deregulation, shippers or other interested parties would have an opportunity to establish certain basic facts pointing to a high probability that a particular pipeline system has significant market power--*i.e.*, the ability to raise its charges for a significant period of time substantially above those that would earn a competitive rate of return. In the few instances where the proponent of regulation is able to satisfy this stringent test, a fuller regulatory proceeding would take place to consider all relevant market facts to determine if significant market power exists. 1/ Of course, if no one comes forward during the interim period or if the case for continued regulation has not been made, the pipeline would be deregulated on the date specified in the legislation. We are also exploring the use of other, concurrent paths to deregulation for particular pipelines in cases where, due to their small size or lack of

---

1/ The data can be developed most efficiently by the pipelines themselves, so that there is every incentive to conduct deregulation proceedings in an expeditious fashion, and there is every reason to believe that all data favorable to the proponents of FERC action will be adduced.

economic significance, one can confidently conclude that the benefits of regulation will be outweighed by its costs, even without a detailed study of the degree of market competition.

The workability of the basic procedure, of course, depends on the test the shipper would have to satisfy. Any such threshold or first-stage test must be a strict one, i.e., it must very strongly predict that the capability of raising and maintaining prices above competitive levels exists. The test would also have to be objective, precise, and verifiable by information reasonably available to the shipper or other proponent of continued regulation. We anticipate that the application of this first-stage test would result in deregulation in the great majority of markets without the need for extensive evidentiary hearings. Simply put, there will likely be only a handful of situations where pipelines will be subject to a second stage test. But in the few cases where it is met, the regulatory body would then be free to consider all relevant evidence adduced by both shippers and the carrier as to the substantiality of competition. Such evidence would deal with all forms of actual and potential competition, intermodal and intramodal, along both the market corridor and at the endpoints of the pipeline market. We believe that such a procedure would, with reasonable efficiency and certainty, result in continued pipeline regulation in only those few cases in which it is genuinely needed.

I should also point out that while deregulating rates, S. 1626 would leave intact a plethora of other Interstate Commerce Act provisions applicable to rate discrimination, published tariffs, access regulation, and the like. Proponents of this approach argue that these provisions should be retained to ensure that competition is not impaired. However, a pipeline that has an economic motivation for engaging in access discrimination may also find it profitable to charge high rates that serve the same purpose of effectively restricting access to the pipeline. But that unregulated rate whose reasonableness may not by law be examined cannot be the basis of a shipper's denial of access claim, even though it may be abundantly clear that the unregulated rate alone is the basis for nonshipment. Put another way, if access regulation is necessary, so is rate regulation; if pipelines are so competitive that rate regulation is superfluous, then so is access regulation.

In fact, if the predicate of deregulation is the existence of vigorous competition among pipelines or among transport modes, certain types of access regulation, such as the requirement of published tariffs from which no deviation is permitted, could be highly anticompetitive, and may even facilitate collusion among competitors. For these reasons, I am very troubled by the notion being advanced that these regulatory provisions, if allowed to continue, alone will remove any residual competitive problems posed by rate deregulation. To the contrary, they may be ineffective in markets where significant market power exists, and may lead to anticompetitive situations in competitive markets.

For example, the posting of tariffs with advance notice of changes and the prohibition on negotiated discounts from tariffs imposed by common carrier regulation would significantly increase the ability of otherwise competing pipelines to price collusively, while at the same time destroying the incentives traditionally associated with price rivalry among competitors. Additionally, the limitations on long-term contracts, while necessary to make common carrier regulation work, deprive shippers of an important ability to bargain, if not for prices, then at least for flexible, accomodating terms and conditions. Interestingly, the available economic data from the period when oil pipelines were common carriers, but before the imposition of any rate of return guidelines, suggest that oil pipelines were able to earn very high profits when common carrier regulation was imposed without rate regulation.

I should also point out that deregulation could, in some circumstances, raise questions under the Sherman and Clayton Acts about the structure of certain oil pipelines, many of which are overlapping joint ventures. The present Interstate Commerce Act scheme of rate and access regulation creates no special Sherman or Clayton Act immunity for oil pipelines. However, the existence of effective regulation is a significant factor in evaluating oil pipeline ownership structure under the antitrust laws. Conversely, the structure of pipeline ownership in any particular market may be a relevant or controlling factor in a deregulation proceeding. To address these concerns in the relatively small number of cases to which they might apply, the Department believes that any deregulation proposal should include an appropriate antitrust savings clause. Specifically, this clause should allow challenges to deregulated joint ventures under the antitrust laws where the joint venture may create, allow or continue the exercise of market power. The issue of appropriate remedies should also be addressed. In some cases, deregulation that appears doubtful may be acceptable if joint venture ownership of the line is eliminated, or if there is a requirement, among others, that ownership in the joint venture be open to all potential shippers.

In summary, Mr. Chairman, we believe that our proposed deregulation process would result in nearly complete deregulation in an orderly, carefully scrutinized manner with appropriate safeguards. Regulation is simply no longer necessary, except for those very few pipelines possessing significant market power.

Attachment #2

OTHER COMMENTS ON H.R. 2677

Sections One and Two: No comments.

Section Three:

For the most part, section 3 of the bill would give statutory recognition to the Commission's present authority. 1/ The only new functions which the Commission would obtain would be those which have until now been retained by the Secretary of Energy under Delegation Order 0204-1, *i.e.*, enforcement functions relating to violations of the section 2, 3, 7, and 8 of the Clayton Act (governing price discrimination between purchasers of commodities,

---

1/ The Commission now exercises not only the authority under section 402(b) of the DOE Organization Act, but also almost all of the authority given to the Secretary of DOE under section 306 of that Act. In paragraph 16 of Delegation Order 0204-1 (Oct. 1, 1977), the Secretary of Energy delegated to the Commission the authority to carry out the functions under:

> The Interstate Commerce Act (49 U.S.C. §1, et. seq.) and other statutes which formerly vested authority in the Interstate Commerce Commission or the chairman and members thereof,/as such statutes relate to the transportation of oil pipelines, to the extent that such statutes are not transferred to, and vested in, FERC by Section 402(b) of the DOE Act; Provided, That this paragraph does not include any of the authority under Section 11 of the Clayton Act (15 U.S.C. §21).

In theory, under the present statutory scheme, the Secretary of Energy could revoke or modify his delegation of authority to this Commission, and this Commission would lose that jurisdiction. Under H.R. 2677, that possibility would no longer exist.

tying arrangements, anticompetitive mergers, and multiple directorship).

Section Four:

This section effectively removes Commission authority to regulate the rates and charges of oil pipelines. This is done by amending sections 1(4), 1(5)(a), 13(4), 15(1), 15(3), 15(6), and 15(7) of the ICA and section 3 of the Act of December 12, 1945 (49 U.S.C. § 65a) to remove all references to "rates, "charges," and "just and reasonable rates." Also removed from these sections are all references to "classifications." The rationale for eliminating Commission authority over classifications is not clear.

H.R. 2677 would, however, continue the substantive obligations of pipeline companies as common carriers, e.g., to furnish transportation upon reasonable request therefor, 49 U.S.C. § 1(4); to maintain just and reasonable regulations, and practices, 49 U.S.C. § 1(6); to charge shippers equal rates for like services, 49 U.S.C. § 2(1); to avoid causing undue or reasonable advantages to any person, 49 U.S.C. § 3(1); to maintain the confidentiality of shipper information, 49 U.S.C. § 15(13); to publish a tariff, 49 U.S.C. § 6(1); and to provide transportation services only in accordance with such tariffs, 49 U.S.C. § 6(7). Furthermore, the remedial provisions of the Interstate

Commerce Act that allow persons injured by a pipeline company's violation of its common carrier responsibilities to sue for damages, either before the Commission or in district court, would remain intact. 49 U.S.C. §§ 8-9. See also 49 U.S.C. §§ 13, 16 (providing procedures for such suits). Oil pipeline companies engaging in willful violations of the Interstate Commerce Act would also remain subject to criminal penalties. See, e.g., 49 U.S.C. §§ 10(1), 41(1). The Commission would retain its various powers of investigation and reporting, 49 U.S.C. §§ 12-14, 20.

Some observations can be made about the regulatory scheme that would result from H.R. 2677. First, there is no provision which would retain or reintroduce rate regulation for any oil pipeline that has monopoly market power in a given geographic area. To the extent that any residual pockets of market power are believed to militate against complete rate deregulation, H.R. 2677 would be overly inclusive. To accommodate a mostly, but not entirely, competitive industry, H.R. 2677 would have to include some mechanism for retaining present rate regulation for these pockets of market power or reestablishing such regulation after a showing of market power had been made.

Second, although the bill appears to continue the Commission's authority to award damages to party complianants for past violations of the provisions of the Interstate Commerce Act, 49 U.S.C. § 16(1), the Commission generally would be prohibited from prescribing in advance the lawful rates, charges, and allowances that might apply to oil pipeline transportation. 2/ To reach prospective violations, the Commission would be dependent on its residual section 15 powers, i.e., its authority to issue cease and desist orders in the case of ongoing violations and its authority to prescribe regulations or practices." 3/ This would limit the scope and, potentially, the effectiveness of the Commission's power to enforce the antidiscrimination provisions of H.R. 2677.

In addition, the courts have interpreted the terms "classifications, regulations, and practices" restrictively. 4/ In Northern Pac. Ry. Co. v. United States, 41 F.Supp. 439, 443 (D. Minn. 1941), aff'd 316 U.S.C. 346, the court stated that the term "practice" as used in the Interstate Commerce Act "cannot have meaning coextensive with any exigency deemed to exist,

---

2/ However, section 15(4) of the Interstate Commerce Act, unchanged by H.R. 2677, authorizes the Commission to prescribe rate divisions.

3/ Sections 13(4) and 15(1) as amended by H.R. 2677. The elimination of the word "classification" from section 15(1) and 13(4) may limit the scope of the Commission's enforcement remedies.

4/ See note 3, supra.

or elastic enough to embrace everything a carrier may do," though the term did embrace those things that "affect arbitrarily and unreasonably the purse of the shipper." See also Baltimore & Ohio R. R. Co. v. United States, 277 U.S. 291, 299-300 (1928) ("The word 'practice' . . . is not susceptible to useful construction . . . [without reference] to acts or things belonging to the same general class as those meant by the words associated with it"). In the courts, unreasonable practices have generally had an immediate impact on rates. See, e.g., Baltimore & Ohio R. R. Co. v. United States, 391 F. Supp. 249 (E.D. Pa. 1975) (carrier furnished more expensive facilities than shipper requested or needed and charged for them), aff'd 594 F.2d 856; Scott Paper Co. v. United States, 372 F. Supp. 721 (E.D. Pa. 1974) (carrier passed on switching charges of connecting carrier), aff'd 419 U.S. 807. Thus, effective control over unlawful practices has historically been linked with control over rates. This link may exist as a matter of logic as well. Possible re-regulation of rates through the enforcement mechanisms of the ICA could be an avenue to consider in addressing this problem.

Assuming the bill deregulates oil pipeline rates, there appears to be no policy justification for continuing the Commission's valuation and depreciation functions with respect to oil pipelines under section 19a of the ICA. 5/ However, the Commission would remain under a statutory duty to compile valuation reports under H.R. 2677. If information on and analysis of valuation and depreciation contribute to other aspects of our regulatory effort, the Commission may desire to continue this effort.

In this vein, oil pipeline regulation also entails enforcement and accounting compliance functions which have been consolidated with rate regulation functions for budget purposes. (There has been no discrete budget for Clayton Act enforcement at DOE). H.R. 2677 may suggest maintenance, perhaps even expansion, of the enforcement and accounting compliance functions. This broad conclusion flows from the intent of the proposed legislation to reduce the existing emphasis on prospective rate regulation; to maintain enforcement of the basic common carrier obligations of pipeline companies; and to add Clayton Act enforcement responsibilities to this Commission's powers. Further, insofar as the purpose or effect of the bill is to rely more heavily on retroactive enforcement of common carrier duties, Congress may wish to consider enhancing the Commission's powers, e.g., by providing for civil penalties for violations and by clarifying the authority of the Commission to seek civil remedies in federal

---

5/ See 49 U.S.C. § 19a, stating that the Commission "shall ascertain and report the value of all pipeline company property. Although the primary purpose of valuation is for ratemaking, the Commission would continue to be obligated by statute to continue its valuation functions unless expressly repealed.

district court.

Finally, H.R. 2677 omits any amendment to section 15(15) of the ICA. Section 15(15) covers "charges" and "allowances" and mentions the power to set "just and reasonable" rates under some circumstances. This reference appears to be contradictory to the statutory scheme present in H.R. 2677 and, possibly, is an oversight in drafting.

Section Five: No comment.

Section Six:

Consideration of a phase-in for deregulation may be appropriate in some circumstances. For example, the DOJ has suggested a threshhold screening of pipeleines to determine which of them may have market power in a given area. Those pipelines which undergo extensive and time-consuming analysis during this screening should not affect the deregulation of pipelines over which there is no controversy. Thus, should some partial rate regulation of the industry be retained, this effective date provision may need redrafting, depending upon the legislative deregulation scheme enacted.

Attachment #3

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FOSSIL AND SYNTHETIC FUELS

OF THE

COMMITTEE ON ENERGY AND COMMERCE HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

H.R. 4488 and H.R. 6815

BILLS TO AMEND THE INTERSTATE COMMERCE ACT AND THE DEPARTMENT OF ENERGY ORGANIZATION ACT TO CLARIFY THE JURISDICTION OF THE FEDERAL ENERGY REGULATORY COMMISSION, TO REFORM AND IMPROVE THE REGULATION OF OIL PIPELINES, AND FOR OTHER PURPOSES

MAY 10 AND SEPTEMBER 28, 1982

Serial No. 97-179

Printed for the use of the Committee on Energy and Commerce

Attachment #3

U.S. GOVERNMENT PRINTING OFFICE
13-367 O WASHINGTON : 1983

Mr. SHARP. Thank you very much, Mr. Baxter.

We will hear briefly from our other two witnesses, before asking the panel questions. We are happy to have with us, also, Mr. Charles Butler III, the Chairman of FERC.

STATEMENT OF C. M. BUTLER III

Mr. BUTLER. Thank you, Mr. Chairman.

I would like to begin at the outset by concurring in something Mr. Baxter noted at the outset of his testimony, and that is that there is also, to my knowledge, no definitive study describing pipeline corridors in which competition can be characterized as workable.

However, it seems to me that there are, at the same time, studies that at least provide a starting point for trying to make a determination of that question.

And along those lines, I would recommend to the committee's attention the study of Edward Mitchell, done for the American Association of Oil Pipelines. [See p. 138.] I do not endorse what Mr. Mitchell said in his study for the very simple reason that it incorporates considerable data that was also included in testimony or other presentations before the Commission in the *Williams Brothers* case.

We are in the process of analyzing those submittals. However, I think it is a useful starting point to try to make a determination that would underlie committee action in passing the statute.

To summarize my testimony, we suggest that there appear to be three basic concerns: First, there is the traditional concern that usually leads to rate-of-return regulation—the presumption that in the absence of regulation, oil pipelines could set unreasonably high rates. Second, there is the concern that pipelines would discriminate among shippers in one of two ways: either by discrimination based on non-cost-based differences in rates, the kind of discrimination one might normally associate with independents and affiliated pipelines, or by a form of discrimination by affiliated pipelines in which a uniformly excessive rate of return is collected both from affiliated and nonaffiliated shippers. The latter is the problem that was sought to be addressed in the 1941 consent decree.

The third basic concern is the problem of undersizing. That theory holds that oil pipeline concerns will make their pipelines smaller than would be optimal in carrying either crude or product to market. It is our judgment that this is largely a theoretical problem.

The real questions, it seems to us, to be addressed by the subcommittee in considering H.R. 4488 from a substantive standpoint are, first of all, the monopolies question and second, the discrimination question.

There is some evidence at this point, and I do not consider it definitive—again, it largely comes from the Mitchell study—that oil pipelines do not in general collect higher than market returns.

Now, it seems to me that there is considerably more work that needs to be done to examine that conclusion, but that conclusion is based on the work of one rather well-known student of the industry.

The second point to the question of whether market power exists is that there appears to be potential competition for pipelines that might be realized in the event that higher than market rates of return were to be collected by existing pipelines.

There is at least anecdotal evidence that this is an effective facet of competition in pipeline markets. Third, there is an important limit placed on pipelines by pipelines serving other routes.

As a general proposition, it appears to be the case, and I emphasize it appears to be the case, that in most producing areas, there is service by a number of pipelines serving alternative routes. Since it is generally immaterial to the producers to whom they sell so long as they get their price, one can argue that there is some element of competition.

Additionally, if a number of pipelines terminate in a single consuming area, they are in competition with each other although they may originate in different locations.

Finally, the pipelines appear to face intermodal competition primarily with water traffic, where rates appear to be roughly equivalent to those charged by oil pipelines. The argument is that although surely there is not perfect competition in these markets in the textbook sense, there is at least the prospect of workable competition in these markets.

It seems to me it is to that end that the committee, in studying this question, should focus its efforts. In that connection, it is useful also to look at the alternatives. If you do find that there is substantial competition in these markets, you have to ask yourself the question whether it is worth the price of regulation which, as is pointed out in my testimony, is neither infallible nor cheap.

Regulation is imperfect and it is a rather blunt regulatory instrument because it is responsible for its own costs and there is a substantial question as to whether or not those costs are worth the benefits that might be gained.

The final question is a difficult one to answer. That is the question of whether or not there are substantial pockets of monopoly power. As was stated in response to the first statement made by Mr. Baxter in his oral presentation, we do not have solid evidence right now of the market characteristics on a market-by-market basis, or in a micromarket sense, and that is a question that also must be taken into account in the committee's consideration.

At this point, our Commission, by and large, has focused its efforts on an attempt to develop a pricing methodology or cost based regulatory methodology for use in regulating the oil pipelines under the Interstate Commerce Act and, consequently, we cannot give you a very definitive and direct answer, except to refer you to the studies conducted by others.

We have not done any of that work. I think at this point I would likewise desist and answer any questions.

[Testimony resumes on p. 36.]

[The prepared statement of Mr. Butler follows:]

STATEMENT OF
C. M. BUTLER III
CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION
BEFORE THE
SUBCOMMITTEE ON ENERGY AND COMMERCE
COMMITTEE ON FOSSIL AND SYNTHETIC FUELS
HOUSE OF REPRESENTATIVES

May 10, 1982

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

Thank you for inviting me to testify today. At the outset I would like to commend the Subcommittee, and Congressman Synar in particular, for going forward with these hearings. They represent an important initiative in the continuing effort to eliminate unneeded and burdensome economic regulation. It is thus an honor to be afforded the opportunity to address today issues relevant to the proposal to deregulate the oil pipeline industry.

The policy questions discussed in my testimony may also be relevant to the Williams and TAPS oil pipeline cases that are now before the Commission. I must emphasize two points, however. First, in those cases the FERC is called on to apply a particular statute, not to make an unfettered policy choice. The second point is that in those cases we must decide on the factual record properly developed in them. My testimony here therefore should not be understood to reflect a commitment to a particular outcome in the Williams and TAPS cases. In view of the evident relationship between those cases and the subject of this hearing, however, my testimony will not deal with particular pipelines. One practical effect of this limitation is that my testimony will be limited to oil pipelines in the lower 48 states.

I would like to begin by setting out the principal regulatory concerns that have shaped the policy debate over oil pipelines. As I will discuss later, I believe that these concerns have been overstated in significant respects and also that they overlook major arguments for deregulation. It is, however, difficult to understand either the policy debate or the existing regulatory structure without some understanding of the opposing view which might be called "the case for regulation."

The basic concerns appear to be three. The first and most straight forward is that, in the absence of regulation, pipelines would set unreasonably high rates. In its traditional form this was a concern with monopoly profits, and the Interstate Commerce Act's response also was traditional: it made it unlawful for oil pipelines to charge "unreasonable" prices. 1/ In 1980 the windfall profit tax added a new dimension to this concern, since it may create an incentive for vertically integrated

---

1/ 49 U.S.C. § 1(5)(1976) (repealed except for its application to oil pipelines and removed from the United States Code, Revised Interstate Commerce Act, Pub. L. No. 95-473, § 4(c), 92 Stat. 1470 (1978). See 49 U.S.C. § 1(5) and chapter 101 note (Supp. III 1979)).

pipelines to set high rates in order to transfer profits from their producing affiliates to the pipeline, thus avoiding the tax. 2/ Although the tax may have created an additional motive to set higher rates, however, it did not increase pipelines' ability to do so. That ability still depends on the existence of monopoly power.

The second concern is that pipelines would discriminate between shippers. Both the issues and the statutory provisions revelant to this concern are complex. Part of the complexity derives from the fact that most oil pipelines are vertically integrated, that is, they are subsidiaries of oil companies that also are shippers on the pipeline. Vertical integration

---

2/ 26 U.S.C. §§ 4986-4998 (Supp. IV 1980). The windfall profits tax (WPT) is calculated as a percentage of the difference between the wellhead price of crude and a base price. Other things being equal, an increase in a pipeline tariff reduces the wellhead price of crude transported by the pipeline. This is because the wellhead price of crude is generally determined as price of oil at the refinery less transportation costs to the refinery. The statute establishing the WPT specifically mandated that the base price of North Slope crude be reduced by any increase in the TAPS tariff. However, the statute established no similar adjustment to lower 48 base prices when lower 48 pipeline tariffs increase. Thus, an increase in the TAPS tariff does not affect the WPT liability of North Slope producers. However, an increase in a lower 48 pipeline tariff reduces the difference between the wellhead price and the base price of crude carried by the pipelines, thereby reducing WPT tax liability. This provides an incentive for lower 48 pipelines that are integrated with crude oil producers to raise their tariffs.

may create additional incentives for discrimination. An independent oil pipeline might seek to discriminate in order to increase its profits by charging a higher rate to less price responsive shippers and a lower rate to more price responsive ones. A vertically integrated pipeline might discriminate for this reason, but it might also do so in order to improve the competitive position of its corporate affiliates in upstream and downstream markets.

Vertical integration may also affect the form of the discrimination. Discrimination consists most obviously of non-cost-justified differences in price or service, or indeed in a refusal to serve certain shippers at all. Discrimination of this kind is expressly dealt with by a number of provisions of the Interstate Commerce Act and other legislation. These provisions are described in an appendix to this testimony. Here I will just briefly sketch their coverage. Basically, the provisions do three things. They guarantee access to a pipeline's services by imposing a common carrier obligation. They make the terms of service publicly available by requiring that services be offered only under the terms of a publicly filed tariff and by forbidding rebates. And they prohibit both discriminatory pricing in general and also certain specific forms of price discrimination.

If a pipeline is vertically integrated, however, even uniform high rates arguably can be discriminatory if they are excessively high, since for independent shippers they constitute a real cost while for affiliates they merely transfer economic rents from one corporate affiliate to another. This kind of reasoning does not appear to have been used in applying the Interstate Commerce Act's prohibitions against discriminatory pricing, but it did form the basis for the 1941 antitrust decree under the antirebate provisions of the Elkins Act. In obtaining that decree the Antitrust Division of the Department of Justice argued that dividends paid to an affiliated shipper constituted rebates and therefore violated the Elkins Act. 3/ Recently the Division has modified this position to argue that revenues lawfully collected under the Interstate Commerce Act may be paid as dividends to owner-shippers. 4/ Under this latter statement of the theory, for vertically integrated oil pipelines the problem of rebates and perhaps the problem of discrimination in general are not clearly distinct from the problem of excessively high rates.

3/ United States v. Atlantic Refining Co., Civil Action No. 14060 (D.D.C. 1941).

4/ Statement of Points and Authorities in Support of Motion of United States of America to Vacate the Final Judgment and for Other Relief at 6, United States v. Atlantic Refining Co., Civil Action No. 14060 (D.D.C. 1981).

The problem of discrimination and excessively high rates are also related in another way. Both assume the existence of monopoly power. A pipeline with no such power would have little ability to charge different rates to different shippers. Moreover, to the extent that it did so, little real harm would result, since shippers could turn to competing pipelines or other transportation modes.

The third concern is with what might be called the undersizing problem. 5/ Briefly stated, the argument is as follows. If an oil pipeline has monopoly power, it can to some degree control the volume of crude oil or refined products flowing out of the upstream markets or into the downstream markets that it serves. Regulation presumably prevents the pipeline from exploiting this power directly by setting higher rates, but if the pipeline is vertically integrated it may be able to exploit the power indirectly by restricting the flow in order to raise prices in its affiliates' markets. The pipeline's common carrier obligation prevents it from restricting the flow simply by denying access to its services. In theory, however, the company can restrict the flow by building a smaller pipeline than would be economically justified by the potential traffic.

5/ Flexner, Oil Pipelines: The Case for Divestiture, in *Oil Pipelines and Public Policy: Analysis of Proposals for Industry Reform and Reorganization* (E. Mitchell ed. 1979).

There is considerable doubt that the undersizing problem has anything more than a theoretical existence. The problem does not in any event appear to be relevant to the present hearings. If the problem exists, it might violate general antitrust laws, but it appears not to violate any existing provision of the Interstate Commerce Act or related legislation, nor would it do so under H.R. 4488.

Let me summarize at this point. There appear to be two regulatory concerns that are relevant to this hearing. One is that, absent regulation, oil pipelines will charge prices that are excessively high; the other is that, again absent regulation, they will discriminate between shippers in price or service. These concerns are interrelated. Both depend on the existence of monopoly power. And for vertically integrated companies, the problems themselves are not wholly distinct, since uniform but high rates may be held to violate one or more of the statutory provisions intended to deal with discrimination.

This analysis suggests that H.R. 4488 raises two general kinds of issues. First, would the repeal of the Interstate Commerce Act's prohibition against unreasonable rates lead to excessively high rates for oil pipeline transportation? Second, is the repeal of that prohibition consistent with the retention of the anti-discrimination provisions of the Interstate Commerce Act and related legislation?

On the first issue, the critical question concerns monopoly power. Or, to state it more precisely, the question is, do oil pipelines possess sufficient market power to justify the retention of federal price controls? I believe that in general they do not. Oil pipelines, like natural gas pipelines, are characterized by economies of scale. Costs per barrel fall as the size of a pipeline increases, so that generally it is cheaper to carry a given volume of oil between two points through a single large pipeline rather than through two or more smaller ones. 6/ However, for several reasons these economies of scale do not in general result in effective monopoly power. First, as a result of market growth, the first pipeline built along a route may prove to be too small, so that one or more additional pipelines are required. As a result, a number of routes are served today by two or more competing pipelines. 7/

Second, the market power of existing pipelines is also limited by the potential competition of pipelines that might be built if rates are sufficiently high. The Interstate Commerce Act establishes no legal barrier to the entry of new

---

6/ E. Mitchell, A Study of Oil Pipeline Competition 6 (1982).

7/ L. Coburn, United States Petroleum Pipelines: An Empirical Analysis of Pipeline Sizing, Appendix II (1980); E. Mitchell, A Study of Oil Pipeline Competition (1982).

oil pipelines; no certificate of public convenience and necessity is required in order to build and operate an oil pipeline. The only question that must be asked by a company considering building a new pipeline is, will it pay? And the higher the rate charged by existing pipelines, the greater the likelihood that this question will be answered in the affirmative. Such potential competition probably is particularly effective where the existing pipeline is an independent one, since the pipeline company then knows that its shippers could build their own pipeline if it sets rates that are too high.

A third important limit on market power is imposed by pipelines serving other routes. The essence of competition is that buyers and sellers have a number of different opportunities available to them. In the case of oil pipelines this can occur even if no route is served by more than a single pipeline. If a producing area is served by a number of pipelines, it generally is unimportant to producers that the pipelines serve different downstream markets and therefore take different routes. Similarly, if a number of pipelines terminate in a single consuming area, they are in competition with each other even though they may originate in different places.

Finally, oil pipelines face intermodal competition. Tankers and barges can compete with pipelines over some long routes, and trucks can compete over short ones. The costs of the other modes will seldom precisely match those of pipelines, but in many cases their actual or potential competition constitutes an effective limit on the oil pipelines' market power.

No one seriously contends that the oil pipeline industry is an example of perfect competition in the textbook sense. Probably most oil pipelines do possess some market power. However, market power in varying degrees characterizes virtually all sectors of the U. S. economy. The question is, does the market power possessed by oil pipelines constitute a sufficient danger to justify the retention of federal price controls? In answering that question, it is very important to be realistic about the regulatory alternative. Price regulation is neither infallible nor cheap. An administrative agency is unlikely to succeed in setting the price that would result from perfect competition; limited resources, imperfect analysis, and conflicting goals make rate regulation a very blunt instrument. Regulation therefore is likely to improve on the performance of an unregulated market only if monopoly or other market imperfections are very substantial. It seems to me to be at least doubtful that the market power possessed by oil pipelines in most markets rises to that level.

Moreover, price regulation itself carries direct and indirect costs. It is impossible at this time to estimate the cost of an effective regulation of all oil pipelines. However, this direct regulatory cost alone may well be comparable to the efficiency gained from effective price regulation,[8] and to this direct cost must be added industry's compliance costs and the distortions in investment and operations that are an inevitable byproduct of imperfect price regulation. Simply stated, for the nation as a whole, it is far less than obvious that the present system of oil pipeline regulation is a good bargain.

A much harder question is whether regulation limited to a relatively few pipelines would be justified on grounds of efficiency or fairness. There do appear to be some markets where pipelines may have significant monopoly power. This has been referred to by some as the "pockets of monopoly power" problem. These markets appear to be of two general kinds. One consists of small isolated producing areas, which are likely to be served by only a single pipeline and may be distant from any competing pipeline. The potential market power of pipelines in such areas is increased by the fact that oil producers, in contrast to natural gas producers, do not enter into long-term contracts with pipelines. Thus, in the oil industry, producers do not contractually fix their economic relationship with pipelines at the time when their bargaining position is strongest, when the reserves are still in the ground and the field is still undeveloped. If oil pipelines were now deregulated, independent producers in fully-developed fields would generally stand in a poor bargaining position in negotiating a transportation contract.

---

[8] T. Morlan, D. Skelly, and A. Reznek, Price Elasticities of Demand for Motor Gasoline and Other Petroleum Products (1981).

Two points should be made to put the producers' problem in perspective, however. The first is that it _is_ the producers' problem: pipeline rates for carrying crude oil from isolated producing fields to refineries are likely to have no measurable impact on the price paid by consumers; they will instead affect the price received by producers. The second point is that the producers themselves do not appear to be concerned about this problem. Producers may be more concerned with the creation of adequate incentives to build new pipelines than with potential price increases that are likely to amount to only a few cents per barrel in most cases.

The second kind of market where little competition may exist consists of inland cities that are served by only a single pipeline. Even for these cities, the potential competition of new pipelines places some limit on the existing pipeline's market power. However, for such cities deregulation might lead to substantially higher oil transportation costs, which probably would in turn be passed on to consumers.

To deal with the problem of inland cities and perhaps also with that of isolated producing areas, Congressional consideration might be given to creating a limited price regulation applicable only where significant market power exists. If this approach is taken, I believe that the presumption should be against regulation; that is, pipelines should be free of regulation unless market power were shown to exist. It also should be made clear that the market power and potential for abuse should be substantial: rate regulation should not be imposed merely because a market does not conform to the ideal of perfect competition.

The second general issue raised by H.R. 4488 concerns the retention of the anti-discrimination provisions of the Interstate Commerce Act and related legislation. The Committee may, as I have suggested, wish to consider creating some sort of regulatory mechanism for dealing with cases where monopoly power does in fact exist. However, the retention of only the current anti-discrimination provisions 9/ for this purpose may create

---

9/ *See* Appendix.

significant problems. The anti-discrimination provisions would of course prevent a pipeline from charging different rates for the same service or from setting rate differentials that were not reasonably cost justified. These provisions would, however, provide little protection where the pipeline that possessed monopoly power was not affiliated with its shippers, since they would not protect the shippers on such a pipeline from rates that were uniformly high.

Perhaps the more serious problem potentially created by retention of these provisions, however, is that they could provide the means for a general reimposition of price controls on the vertically integrated firms that constitute the larger part of the industry. Under the Antitrust Division's current interpretation of the Elkins Act, 10/ that Act's antirebate provision makes it illegal for vertically integrated pipelines to pay dividends in excess of a "reasonable" return. 11/ At present that return can be based on the FERC's general regulation

---

10/ 49 U.S.C. §§ 41-43 (1976) (repealed except for its application to oil pipelines and removed from the United States Code, Revised Interstate Commerce Act, Pub. L. No. 95-473, § 4(c), 92 Stat. 1470 (1978). *See* 49 U.S.C. § 1(5) and chapter 101 note (Supp. III 1979)).

11/ Statement of Points and Authorities in Support of Motion of United States of America to Vacate the Final Judgment and for Other Relief at 6, United States v. Atlantic Refining Co., Civil Action No. 14060 (D.D.C. 1981).

of pipeline rates, but if pipelines were freed from general rate regulation, payment of dividends to affiliated shippers could make them vulnerable to treble damage actions under the Elkins Act. Moreover, a logical extension of the Antitrust Division's argument would imply that the Interstate Commerce Act's own prohibitions against discriminatory rates could be converted into a prohibition against uniform but high rates in the case of these vertically integrated oil pipelines.

It is difficult to assess the seriousness of this problem. It depends not only on the interpretation of the provisions concerned but also on the likelihood that the provisions will be used in this way by the Antitrust Division, by the FERC, or by private parties. What can be said at this point is that these provisions constitute an unpredictable danger that regulation through regular administrative process will simply be converted into regulation through litigation. To avoid this danger the committee may wish to consider clarifying the meaning of the provisions in question, so that they are not violated by uniform high prices or by dividends paid to corporate affiliates. To the extent that high prices and excessive dividends are viewed as a serious problem, it appears that it would be preferable to deal with the problem directly through continued price regulation in a few markets rather than indirectly through prohibition against discriminatory prices and rebates.

APPENDIX

Statutory Discrimination Provisions Applicable to Oil Pipelines

A. *Common carrier obligations*

Section 1(4) of the Interstate Commerce Act 1/ obligates every common carrier, upon reasonable request, to furnish transportation. Common carriers are also required to establish through routes with other carriers and to establish just and reasonable rates. Oil pipelines are common carriers by virtue of § 1(3)(a) of the Interstate Commerce Act.

B. *Tariff and rebate restrictions*

A common carrier is required by § 6(1) of the Interstate Commerce Act to file tariff schedules showing all transportation rates and charges. Filed tariffs may not be changed without 30 days' notice to the Commission, § 6(3). Carriers are prohibited from transporting unless the rates and charges for such transport are on file nor may a carrier charge compensation which differs from the filed tariff, § 6(7).

Section 10 of the Interstate Commerce Act contains complimentary criminal penalties for false billing or classification by a common carrier; for shippers who obtain lower rates through false billing, classification, or claims; and for inducing unjust discrimination. (This latter provision also subjects the person and common carrier involved to civil liability.) In addition, § 15(15) requires the filed tariffs to show the allowances made by a carrier for any related service to the carrier by a shipper.

The Interstate Commerce Act also contains two distinct rebate prohibitions. Section 2 of the 1887 Act, declares unlawful any special rate, rebate, drawback, or device through which a common carrier is compensated by a person to a greater or lesser extent than the carrier is compensated by another similarly situated person.

1/ 49 U.S.C. § 1(4)(1976)(repealed except for its application to oil pipelines and removed from the *United States Code*, Revised Interstate Commerce Act, Pub. L. No. 95-473, § 4(c), 92 Stat. 1470 (1978). *See* 49 U.S.C. § 1(5) and chapter 101 note (Supp. III 1979)).

The Elkins Act 2/ amended the Interstate Commerce Act in 1903, strengthening both the filed tariff and rebate provisions. It established criminal penalties (1) for the willful failure to file, publish, or observe tariffs, and (2) for the knowing offer, grant or gift, or solicitation, acceptance, or receipt of any rebate, concession, or discrimination by which property was transported for less than the filed rate, § 41(1). The Elkins Act also imposed fines treble the amount of the rebate, on those guilty of receiving rebates from a carrier § 41(3). 3/

C. Price discrimination

There are four statutory provisions applicable to oil pipelines which prohibit price discrimination. Section 2 of the Interstate Commerce Act declares rebates to be unjust discrimination. Section 3 makes it unlawful for a common carrier to give any undue preference or advantage or to subject any person or place to any undue or unreasonable prejudice or disadvantage. Interestingly, the prohibitions of § 3 do not apply to discrimination, prejudice, or disadvantage to the traffic of any other carrier. Section 4 prohibits a common carrier from charging greater compensation for short hauls over the same line and in the same direction as long hauls. 4/

2/ 32 Stat. 847 (1903), as amended, 34 Stat. 587 (1906), 49 U.S.C. §§ 41-43 (1976).

3/ In the motion of the Justice Department to vacate the 1941 consent decree limiting the oil pipelines' return on equity, a central issue is the circumstances under which a dividend by an affiliated company constitutes a rebate. Statement of Points and Authorities in Support of Motion of United States of America to vacate the Final Judgment and for Other Relief at 6, United States v. Atlantic Refining Co., Civil Action No. 14060 (D.D.C. 1981).

4/ Section 13(4) of the Interstate Commerce Act prohibits state regulations from discriminating against interstate or foreign commerce, and § 26(c) contains a similar provision for state taxes.

The final price discrimination provision is § 2 of the Clayton Act, known as the Robinson-Patman Act, 5/ under which it is unlawful to discriminate in price between different purchasers of commodities of like grade and quality where such discrimination may be substantially to lessen competition or tend to create a monopoly, unless the price differentials make allowance for differences in the cost of manufacture, sale or delivery. 6/

5/ Robinson-Patman Act, 15 U.S.C. §§ 13-136, 21a (1976).

6/ The statutory antitrust immunity of oil pipelines is limited to rate agreements between carriers which have been approved by the Commission. 49 U.S.C. §5b (1976). The authority to enforce the Robinson-Patman Act as it applies to oil pipelines resides in DOE. 42 U.S.C. § 7155 (Supp. II 1978).

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON 20426

IN REPLY REFER TO:

MAY 27 1982

Honorable Philip R. Sharp
Chairman, Subcommittee on Fossil
and Synthetic Fuels
Committee on Energy and Commerce
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

During the hearings held by your Subcommittee on May 10, 1982, I was asked to provide information to you regarding the number of oil pipeline rate cases pending before the Federal Energy Regulatory Commission. Currently, there are approximately 125 oil pipeline cases pending before the Oil Pipeline Board (OPB). This number reflects cases in which pipelines have requested a general rate increase. (In arriving at the estimate of pending cases, cases that had been consolidated into one proceeding were counted as one rate case.) Although protests have been filed in other pending oil pipeline matters, none has been filed in the rate cases. If deregulation occurs, it will terminate the regulation of oil pipeline rates prospectively. However, until that time oil pipeline rates will continue to be subject to regulation by the Commission. The OPB routinely suspends rate filings for one day and makes them subject to investigation. Thus, the pending rate cases will have to be resolved regardless of the success of deregulation efforts.

In addition there was an inquiry regarding the comparability of barge rates and pipeline rates for oil pipelines. The most recent study is that of Edward J. Mitchell (A Study of Oil Pipeline Competition, 19, American Enterprise Institute, 1982). He reported that oil pipeline transportation costs ranged between 4.4-23.2 cents per 100 barrel-miles, with an average of 14.2 cents. The comparable cost for barge transportation ranged between 2.2-31.9 cents per 100 barrel-miles, with an average of 8.9 cents. A number of studies are reviewed in John A. Hansen's Competitive Aspects of the United States Petroleum Pipeline Industry: Implications for Regulatory Analysis (35-36, Ph.D. dissertation, Yale Univ., 1980). According to Hansen, J. K. Purcey in The Pipeline Segment of the Domestic Petroleum Industry: Structure and Conduct (108, Ph.D. dissertation, Univ. of Okla., 1978) estimated that the cost of oil pipeline transportation fell within a range of .17-.60 cents per ton-mile, while the cost of barge transportation lay between .15-.60 cents per ton-mile. A 1975 study for The Association of Oil Pipelines concluded that the cost of shipping oil per 100 barrel-miles ranged between 1-6 cents for tankers, 4-15 cents for barges, and 2.5-12 cents for oil pipelines (Ulysses J. Legrange, Testimony before the ICC in Ex Parte 308: Valuation of Common Carrier Pipelines, 13, 1977). In the final study summarized by Hansen, Ann F. Friedlander found that the cost of pipeline transportation ranged between .006-.012 cents per ton-mile, while barge transportation averaged about .4 cents per ton-mile. (The Dilemma of Freight Transport Regulation, 45-50, Brookings Institution, 1969). Most of these studies support the position that both pipeline and water carrier transportation costs vary widely but that on average the costs of the two modes are fairly similar. Friedlander's work, indicating lower costs for oil pipelines, presents the only contrary view.

If I can be of further service to you or to the Subcommittee on Fossil and Synthetic Fuels, please do not hesitate to call upon me.

Sincerely,

C. M. Butler III
Chairman

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON 20426

IN REPLY REFER TO:

OCT 4 1982
OCT 5 1982
OCT 1

Honorable Philip R. Sharp
Chairman, Subcommittee on Fossil
and Synthetic Fuels
Committee on Energy and Commerce
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

Prior to the hearings held by your Subcommittee on May 10, 1982, concerning the deregulation of oil pipelines proposed by H.R. 4488 and its companion bills, you sent me a list of questions which it was hoped could be addressed in my testimony. As I indicated in my appearance before you on May 10th, a few of those matters would require more thorough inquiry and, thus, a later response. Today, with my apologies for its tardiness, I am providing that response as well as a bibliography on oil pipeline regulation and the answers to some additional, informal inquiries made by Mr. Runge, a member of your Subcommittee staff.

My testimony addressed the general questions of the desirability of deregulating oil pipelines, including TAPS, and the effect of decontrol on consumers and independent producers as well as my opinion regarding the existence of competition within the oil pipeline industry (questions 1, 2, 3, 5 and 21). The position taken in my testimony identified two problems which concern those considering the workability of decontrol of oil pipelines: the possibility that the pipelines might charge unreasonably high rates and the ability of the pipelines to discriminate between shippers. The capacity of any pipeline to engage in such abuses depends upon its market power. The concerns aroused on this issue are exacerbated by the degree of vertical integration in the petroleum industry. However, in general, I believe that petroleum pipelines do not possess sufficient market power to justify federal price controls. On the one hand, market growth and high rates attract competitors within the industry. On the other hand, petroleum transportation by pipeline is competitive with water-borne traffic over long distances; over short hauls even trucks can compete. Obviously, the pipeline industry is not a textbook model of competition; however, the true question is whether regulation is worth the price. Regulation itself has both direct and indirect costs. It is at best a very inexact method fraught with unforeseen consequences.

As I stated in my testimony, however, there apparently do exist some pockets of monopoly power in the pipeline industry. These are probably of two kinds: isolated producing areas served by a single pipeline and inland cities served by only one pipeline. Congress may, I suggested, wish to consider developing limited price regulation applicable only where significant market power exists. In regard to this issue, I would like to take this opportunity to advise you of a joint study being conducted by the Federal Energy Regulatory Commission, the Department of Energy, and the Department of Justice on oil pipeline market concentration. It is hoped that the study can be completed before the next Congress and, thus, may provide timely guidance to those concerned about the competitive implications of oil pipeline decontrol.

One of the more important concerns relevant to competition relates to the allegations of discrimination by shippers (question 4). Under the Interstate Commerce Act as amended by the Hepburn Act, oil pipeline companies are required to operate as common carriers. Besides requiring just and reasonable rates, the Interstate Commerce Act requires oil pipeline companies to provide transportation upon reasonable request, to establish and follow just and reasonable transportation practices, to avoid undue discrimination in performing transportation services, and to perform services and offer facilities only under terms and conditions that have been clearly stated in public tariffs filed with the Commission. In extending the Interstate Commerce Act to oil pipelines, Congress was primarily concerned with the anticompetitive use of oil pipelines by integrated oil companies. In United States v. Champlin Refining Company, 1/ the Supreme Court stated that Congress extended the Interstate Commerce Act to oil pipelines "to eliminate the competitive advantage which ... companies might possess from the exclusive ownership of a pipeline."

Under these guidelines, the Commission is prepared to examine problems with minimum tender specifications, batching, prorationing policies, terminaling facilities, and connections. Like its predecessor the ICC, however, the FERC has received few complaints of oil pipeline misconduct. Since this Commission acquired jurisdiction over the transportation of oil by pipeline on October 1, 1977, very few complaints have been filed with the Commission. The complaints that have been filed involved allegations of: (1) denial of access to an oil pipeline under Section 1(6) of the ICA, (2) discrimination against crude oil marketers because of discontinuance by the

---

1/ 341 U.S. 290, 297 (1951).

oil pipeline of documentation for transfers of oil among the crude oil marketers, (3) an improper allocation of oil lost in transit (line loss) among shippers, and (4) an allegation that intrastate rates may be discriminatory as compared with interstate rates in violation of Section 13(4) of the ICA. The dearth of complaints possibly may be attributed in part to the reluctance of shippers to set off a round of retaliatory conduct, but it may also be attributable to the fact that shippers often have substantial bargaining power in their own right and do not require the Act's protection. In this regard, it should be recognized that transportation charges are a small component in the refinery cost of crude and the retail cost of petroleum products and that the impact of discriminatory pipeline practices on market prices and consumers is, in general, indirect and difficult to quantify. Finally, uncertainty, due to lack of precedents, as to the scope of the Act's protections may also be a factor which has discouraged shippers from filing complaints and undertaking the risks of litigation.

The Commission is carrying on private staff investigations into possible discriminations and violations of common carrier responsibility. Several such investigations are ongoing. It would be inappropriate to discuss details of these investigations in a public forum because of the private rights involved, but it can be said that they do involve denial and restriction of access to pipeline facilities, forced sales, unequal treatment of shippers, performance of untariffed services, disclosure of confidential shipment information, tampering with shipments, and other practices which may violate the ICA. One of these private investigations concerned allegations of a pipeline company's facilitation of improper crude reseller activity.

In addition to my views on possible shipper allegations of discrimination, you inquired about my opinions as to potential future construction and ownership of pipelines which would occur with and without deregulation (question 6). In theory deregulation might lead to less investment in new pipelines as pipelines limit their capacity in order to obtain greater monopoly profits in the absence of price regulations. However, studies of pipeline undersizing under the existing regulatory regime, which would be directed at obtaining monopoly profits in either the upstream or downstream markets, suggest that this would not occur. It is likely, rather, that deregulation would tend to lead to greater investment by reducing the risk that pipelines would be unable to charge rates sufficient to earn a competitive rate of return on their investment in new facilities.

You also requested an analysis of H.R. 4488 (question 8). 2/ Although the purpose of the bill is to deregulate rates, the bill can be interpreted to retain the concept of just and reasonable rates and charges under sections 1(4) and 1(5) of the Interstate Commerce Act. 49 U.S.C. §§1(4)-(5). Thus, the legal impact of the bill as drafted is unclear. In addition, the bill may remove a major portion of the Commission's powers to remedy discrimination. In order to discuss the implications of H.R. 4488 I would like to analyze first the authority of the FERC over oil pipelines, the impact of the bill on our jurisdiction, the possible administrative consequences of H.R. 4488, and finally, I would like to compare H.R. 4488 to deregulation programs in effect for other industries.

Commission's Authority Over Oil Pipeline Companies

This Commission's present jurisdiction over oil pipeline companies is based primarily on two grants of authority, both of which became effective on October 1, 1977. The broader of these appears to be Delegation Order 0204-1, issued by the Secretary of Energy pursuant to the Department of Energy Organization Act, P.L. 95-91. In paragraph 16 of that order, the Secretary of Energy delegated and assigned to this Commission the authority to carry out the functions under:

> The Interstate Commerce Act (49 U.S.C. §1, et. seq.) and other statutes which formerly vested authority in the Interstate Commerce Commission or the chairman and members thereof, as such statutes relate to the transportation of oil pipelines, to the extent that such statutes are not transferred to, and vested in, FERC by Section 402(b) of the DOE Act: Provided, That this paragraph does not include any of the authority under Section 11 of the Clayton Act (15 U.S.C. §21).

The source of the DOE oil pipeline regulation authority delegated by this order is section 306 of the Department of Energy Organization Act, which grants DOE "such functions

---

2/ Section 4 of the bill is directed at the authority of the FERC to regulate oil pipeline rates. Section 4 repeals the Department of Energy Organization Act to the extent that act vested "authority to suspend, determine, or prescribe rates, fares, or charges for the transportation of oil by pipeline." An exception is included in Section 4(b) preserving the Commission's authority over the Trans-Alaska Pipeline System. Other sections of the bill are discussed *infra*.

set forth in the Interstate Commerce Act, and vested by law in the Interstate Commrce Commission ... as relate to transportation of oil by pipeline," except insofar as those functions had been transferred to this Commission elsewhere in that Act. 3/

Reference to the legislative history of the Department of Energy Organization Act, and to the Interstate Commerce Act, demonstrates that the delegation to DOE under section 306 includes access regulation, rate regulation, equal treatment, facility maintenance and interconnection, antitrust, reporting, and auditing components. 4/ The effect of Delegation Order 0204-1 is to transfer all of these functions to this Commission except insofar as they are derived from section 11 of the Clayton Act, 15 U.S.C. §21. Under that section, the Secretary

---

3/ The scope of the Commission's oil pipeline regulation responsibilities under Section 402(b) of the Department of Energy Organization Act is discussed *infra*.

4/ The functions transferred to DOE from the ICC under this provision were described in the Joint Explanatory Statement of the Committee of Conference. The Conference Report stated:

> "The current ICC oil pipeline functions under the Interstate Commerce Act which are transferred to the Department include, but are not limited to, the following (citations are to sections in Chapter 3 of Title 1 of Title 49):
>
> "(1) The pipelines' duty '... to provide and furnish transportation upon reasonable request therefor ...' [Sections 1(4) and 15(3)] and establish '... just and reasonable rates, fares, charges and classifications ...' [Sections 1(4), (5) (6)]
>
> "(2) The prohibition against subjecting any shipper, locality or territory ... to any undue or unreasonable prejudice or disadvantage in any respect whatsoever ...' [Section 3)]
>
> "(3) The prohibition against charging or receiving "any greater compensation in the aggregate for the transportation ... of like kind of property for a shorter than for a longer distance over the same line or route in the same direction, the shorter being included within the longer, or to charge any greater compensation as a through rate than the aggregate of the intermediate rates....' [Section 4]

retains the power to enforce compliance with sections 2, 3, 7 and 8 of the Clayton Act, governing respectively price discriminations between purchasers of commodities, tying

---

(Footnote continued)

> "(4) The requirement that every pipeline file with the Commission all rates, charges, classifications, regulations and practices for transportation between all points on its system [Section 6] and not demand or collect any different compensation for transportation than specified in its filed tariff [Sections 2 and 6(7)]
>
> "(5) The authority of the Interstate Commerce Commission to review all pipeline rates, and, if it determines that a rate is unjust or unreasonable, or unjustly discriminatory or unduly preferential, to suspend such rate and determine the just and reasonable rate [Sections 15(1) and (7)]
>
> "(6) The prohibition against a pipeline's entering into any agreement with any other pipeline for the pooling or division of traffic service, or gross or net earnings, except upon the specific approval by order of the Interstate Commerce Commission [Section 5(1)]
>
> "(7) The duty of every pipeline to file annual, periodical, and special reports as the Interstate Commerce Commission may require and in the form so required [Section 20(4)]
>
> "(8) The authority of the Interstate Commerce Commission to prescribe a Uniform System of Accounts for pipelines which shall be used by all pipelines [Section 20(3)] and to prescribe rates of depreciation for pipeline property which must be used by all pipelines [Section 20(4)]
>
> "(9) The authority of the Interstate Commerce Commission or any duly authorized special agent, accountant or examiner at all times to inspect all accounts, books, records, correspondence or other documents of every pipeline [Section 20(5)]
>
> "(10) The authority to provide a basic and annual valuation of each pipeline's property [Section 19a]"

arrangements, anticompetitive mergers, and multiple directorships. 5/

The other major basis for the Commission's jurisdiction over oil pipeline companies is section 402(b) of the Department of Energy Organization Act, which states:

> "There are hereby transferred to, and vested in the Commission all functions and authority of the Interstate Commerce Commission or any officer or component of such Commission where the regulatory function establishes rates or charges for the transportation of oil by pipeline or establishes the valuation of any such pipeline." [Emphasis added.]

It is unclear what Congress meant by the emphasized clause and consequently how it intended the functions previously exercised by the ICC to be divided between the Secretary of Energy and the Commission. (The relevant legislative history provides no guidance.) However, as a practical matter, because of Delegation Order 0204-1, the distinction and division have been unimportant: The cumulative effect of Delegation Order 0204-1 and section 402(b) of the Department of Energy Organization Act has been to delegate to the Commission the primary responsibility for the federal economic regulation of the oil pipeline industry, and to vest the Commission with all of the functions formerly exercised by the ICC, except those under Clayton Act §11.

Potential Impact of H.R. 4488 on FERC's Jurisdiction

One effect of H.R. 4488 would be to modify the scheme of delegation under which this Commission presently exercises its regulatory authority of oil pipeline companies. For the most part, section 3 of the bill would merely give statutory recognition to the Commission's present authority. 6/ The only new functions which the Commission would obtain would

---

5/ See generally W. K. Jones, Authority of The Department of Energy to Regulate Anticompetitive Aspects of Petroleum Pipeline Operations 102-166 (prepared for U.S. Department of Energy: June 30, 1978) (discussing authority of DOE to enforce the Clayton Act under section 306 of the DOE Organization Act).

6/ In theory, under the present statutory scheme, the Secretary of Energy could by fiat revoke or modify its delegation of authority to this Commission, and this Commission would lose that much of its jurisdiction. Obviously, under the proposed law, that possibility would no longer exist.

be those which have until now been retained by the Secretary of Energy under Delegation Order 0204-1, i.e., enforcement functions relating to violations of the Clayton Act. These functions would complement enforcement activities within this Commission. 7/

The other major effect of H.R. 4488 would be to repeal by implication the Interstate Commerce Act insofar as it provides this Commission with the authority "to suspend, determine, or prescribe rates, fares, and charges for the transportation of oil by pipeline," preserving such authority only with regard to the trans-Alaska pipeline. See H.R. 4488 §4. Nevertheless, because Section 4 of the bill is intended to amend the Department of Energy Organization Act and has not been drafted in terms of specific language to be added to, and deleted from, the Interstate Commerce Act, its potential effect is ambiguous. The common understanding of this provision is that it would result in "rate deregulation" for oil pipelines. 8/ Rate deregulation, in fact, appears to be the primary goal of the bill's proponents and is frequently articulated in conjunction with an intent to protect the Commission's authority over the "common carrier responsibilities" of oil pipeline companies. Significantly, however, the bill does not address whether oil pipeline companies will continue to bear the duty of charging just and reasonable rates, which may be not only an historical common carrier obligation but, moreover, may be inextricably intertwined with service regulations.

The proposed bill seeks to achieve its dual goal of deregulating rates and preserving the Commission's authority over the common carrier obligations of oil pipelines by language which, narrowly read, amends section 15 of the Interstate Comerce Act, 49 U.S.C. §15. Section 15(1) provides:

7/ The Assistant General Counsel for Enforcement at DOE has stated that there are no investigations or proceedings that are being conducted presently in that office, and there have been none since the office was established. Telephone conversation with Robert Heiss, Assistant General Counsel for Enforcement, Department of Energy (December 8, 1981); telephone conversation with Robert Gerring, Director of Programs Operations, Office of Enforcement, Economic Regulatory Administration, Department of Energy (December 8, 1981) and telephone conversation with Joan Nichols, Assistant to Carl Corrallo, Solicitor, Office of the Special Counsel for Compliance, Economic Regulatory Administration, Department of Energy, December 11, 1981).

8/ See, e.g., AOPL Gains DOE Support on Deregulation Pitch In Inside FERC (November 23, 1981), at 1.

> "Whenever, after full hearing, ... the Commission shall be of opinion that any ... rate, fare, or charge ..., or that any ... classification, regulation, or practice whatsoever ..., is or will be unjust or unreasonable or unjustly discriminatory or unduly preferential or prejudicial, or otherwise in violation of any of the provisions of this chapter, the Commission is authorized ... to determine and prescribe what will be the just and reasonable rate, fare, or charge ... to be thereafter observed in such case, ... and what classification, regulation or practice or will be just, fair and reasonable, to be thereafter followed." [Emphasis added.]

The emphasized portion represents language of the Interstate Commerce Act which is similar to the language of section 4 of the bill. 9/ Section 15(3), concerning "joint rates", is similar to the same as section 15(1). Section 15(15) concerns allowances granted by carriers for transportation services furnished by the shipper and provides, inter alia, that the Commission may after hearing determine and prescribe the maximum allowance that is reasonable. In effect, allowances are negative adjustments to the rates and charges of the pipeline company and would accordingly fall within the scope of the proposed legislation. Thus, a reasonable interpretation of H.R. 4488 may be that it would delete and invalidate these sections to the extent that they provide this Commission with the statutory basis to remedy violations of the Interstate Commerce Act by prescribing pipeline rates and charges. 10/

Section 15(7), concerning suspensions, appears also to be affected by H.R. 4488. Section 15(7) states:

> "Whenever there shall be filed with the Commission any schedule stating a new ... rate, fare, or charge, or any new ... classification, or any new ... regulation or practice affecting any rate, fare, or charge, the Commission shall have ... authority, either upon a hearing concerning the

---

9/ Whereas section 15(1) refers to the Commission's authority to determine and prescribe "just and reasonable" rates, fares, and charges, section 4 omits the reference to "just and reasonable."

10/ In theory, the Commission would retain its power to remedy the same violations by prescribing classification, regulations or practices. The scope of the Commission's authority over classifications, regulations and practices is discussed infra.

> lawfulness of such rate, fare, charge, classification, regulation, or practice, and pending such hearing and the decision thereon the Commission ... may from time to time suspend the operation of such schedule and defer the use of such rate, fare, charge, classification, regulation, or practice, but not for a longer period than seven months beyond the time when it would otherwise go into effect." [Emphasis added.] 11/

As an adjunct to its powers of suspension, the Commission may cause the pipeline companies to account for and refund amounts collected under interim rates in effect during the suspension period and may prescribe the rates which will be effective during the suspension period. In re Trans-Alaska Pipeline Rate Cases, 436 U.S. 631 (1978). What would happen to the Commission's powers to cause pipeline companies to account for collections made under suspended items is unclear but a broad reading of H.R. 4488 could preclude retroactive adjustments to pipeline company collections which were consistent with their filed tariffs, whether provisions of those tariffs were lawful or not. 12/

H.R. 4488 is apparently not intended to have any direct impact on the substantive obligations of pipeline companies as common carriers, 13/, e.g., to furnish transportation upon reasonable request therefor, 49 U.S.C. §1(4); to maintain just

---

11/ See also section 15(3), relating to the suspension of joint rates.

12/ Note that a narrow reading of the proposed bill could merely eliminate the power of the Commission under section 15(7) to defer the effectiveness of a proposed initial rates, fares, and charges, while preserving the Commission's authority to defer the effectiveness of "classifications, regulations, or practices". See discussion infra concerning the scope of the latter.

13/ There exists the collateral question of whether it is a fundamental common carrier responsibility to establish just and reasonable charges, see 49 U.S.C. §§1(4)-1(5), which would not be expressly repealed. See generally Section 2 of the proposed bill, stating that the purpose of the bill is "to foster a competitive oil pipeline industry and assure services on an equal basis without unjust discrimination" and compare with the National Transportation Policy Act of 1940, 54 Stat. 899, which amended the Interstate Commerce Act by declaring that the Act was intended to provide for "maintenance of reasonable charges for transportation services" as well as to protect from "unjust discriminations, undue preferences or advantages, or unfair or destructive competitive practices."

and reasonable classifications, regulations, and practices, 49 U.S.C. §1(6); to charge shippers equal rates for like services, 49 U.S.C. §2(1); to avoid causing undue or reasonable advantages to any person, 49 U.S.C. §3(1); to maintain the confidentiality of shipper information, 49 U.S.C. §15(13); to publish a tariff, 49 U.S.C. §6(1); and to provide transportation services only in accordance with such tariffs, 49 U.S.C. §6(7). Furthermore, procedural provisions of the Interstate Commerce Act, allowing persons injured by a pipeline company's violation of its common carrier responsibilities to sue for damages, either before the Commission or in district court, would remain intact. 49 U.S.C. §§8-9. *See also* 49 U.S.C. §§13, 16 (providing procedures for such suits). Oil pipeline companies engaging in willful violations of the Interstate Commerce Act would also remain subject to criminal penalties. *See, e.g.,* 49 U.S.C. §§10(1), 41(1). The Commission would retain its various powers of investigation and reporting, 49 U.S.C. §§12-14, 20.

Nevertheless, the substantive obligations and duties of pipeline companies could effectively be placed in some doubt by their possible unenforceability under H.R. 4488 and its companion, S. 1626 (question 17). Although the bills appear to continue the Commission's authority to award damages to party complainants for past violations of the provisions of the Interstate Commerce Act, 49 U.S.C. §16(1), the Commission generally would be prohibited from prescribing in advance the lawful rates, charges, and allowances that might apply to oil pipeline transportation. 14/ To reach prospective violations, the Commission would be dependent on its residual section 15 powers, i.e., its authority to issue cease and desist orders in the case of ongoing violations and its authority to prescribe "classifications, regulations, and practices." In view of the proposed abolition of the Commission's rate jurisdiction, the potential scope and effectiveness of service regulation would be limited. In the past, the courts have interpreted "classifications, regulations, and practices" restrictively. *In Northern Pac. Ry. Co. v. United States*, 41 F.Supp. 439, 433 (D. Minn. 1941), *aff'd* 316 U.S. 346, the court stated that the term "practice" as used in the Interstate Commerce Act "cannot have meaning coextensive with any exigency deemed to exist, or elastic enough to embrace everything a carrier may do," though the term did embrace those things that "affect arbitrarily and unreasonably the purse of the shipper." *See also Baltimore & Ohio R. R. Co. v. United States*, 277 U.S. 291, 299-300 (1928) ("The word 'practice' ... is not susceptible

---

14/ *But see* section 15(4) of the Interstate Commerce Act, authorizing the Commission to prescribe rate divisions.

to useful construction ... [without reference] to acts or things belonging to the same general class as those meant by the words associated with it"). In the courts, unreasonable practices have generally had an immediate impact on rates. See e.g., Baltimore & Ohio R. R. Co. v. United States, 391 F. Supp 249 (E.D. Pa. 1975) (carrier furnished more expensive facilities than shipper requested or needed and charged for them), aff'd 594 F.2d 856; Scott Paper Co. v. United States, 372 F. Supp 721 (E.D. Pa. 1974) (carrier passed on switching charges of connecting carrier), aff'd 419 U.S. 807. Thus, effective control over practices may logically require some control over rates.

Potential Administrative Consequences of H.R. 4488

Because it is unclear whether the proposed legislation would affect the duty of pipeline companies to change just and reasonable rates, the administrative and budgetary consequences of H.R. 4488 are also unclear. In the FY 1981 budget request, about $4.1 million was allocated to oil pipeline regulation at FERC 15/, covering three rate regulation functions:

(1) tariff and rate review

(2) valuation

(3) depreciation

Assuming that the duty to charge just and reasonable rates would be eliminated by the bill, there appears to be no policy justification for continuing the valuation and depreciation functions. However, as discussed above, the actual impact of H.R. 4488 on rate regulation, is subject to dispute and there may be a continuing public interest in reviewing the tariffs submitted by the pipeline companies. Furthermore,

---

15/ This figure excludes $1.8 million which was requested for the Trans-Alaska Pipeline System project which would be unaffected by H.R. 4488.

the Commission is under a statutory duty to compile valuation reports. 16/ To the extent that tariff and rate review, valuation, and depreciation status functions represent valid informational and analytical endeavors which contribute to the overall regulatory effort, retention of those staffs may also be appropriate.

Oil pipeline regulation also entails enforcement and accounting compliance functions which have been consolidated with rate regulation functions for budget purposes. (There has been no discrete budget for Clayton Act enforcement at DOE.) The spirit of H.R. 4488 may suggest maintenance, if not expansion, of the enforcement and accounting compliance functions. This broad conclusion would flow from the intent of the proposed legislation to reduce the existing emphasis on prospective rate regulation; to maintain, if not increase, enforcement of compliance with the basic common carrier obligations of pipeline companies; and to add Clayton Act enforcement responsibilities to this Commission's powers. Further, insofar as the purpose or effect of the bill is to rely more heavily on retroactive enforcement of common carrier duties, Congress may wish to consider enhancing those powers, e.g., by providing for civil penalties for violations of the Interstate Commerce Act and clarifying the litigation authority of the Commission to seek civil remedies in federal district court.

Comparison of H.R. 4488 with other deregulation Laws

Comparison of H.R. 4488 with other efforts of Congress to deregulate transportation industries, viz., the Motor Carrier Act of 1980, Pub. L. No. 96-296, 94 Stat. 793 (July 1, 1980) and with the Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (Oct. 24, 1978), is somewhat useful in predicting the potential impact of H.R. 4488, although limited by differences in the regulatory regime to be changed.

16/ See 49 U.S.C. §19a, stating that the Commission "shall" ascertain and report the value of all pipeline company property. Although the primary purpose of valuation is for rate-making, unless expressly repealed, the Commission would continue to be obligated by statute to continue its valuation functions. See also United States v. Atlantic Rfg. Co., Civil Action No. 14060 (D.C.D.C. December 23, 1941). In part III of the Consent Decree which provided the basis for the final judgment in that case, a large part of the oil pipeline industry agreed to pay no more than 7% of their valuation in dividends and other payments to the oil companies which owned them. This Consent Decree has been a major underpining for the valuation program. However, the Justice Department has recently moved to vacate the Consent Decree.

Unlike the oil pipeline industry, the trucking industry and airline industry were regulated comprehensively and actively for many years. The agencies overseeing those industries generated broad schemes of regulation which included route restrictions and extensive service requirements, as well as rate regulation. Recognizing that the economic entry barriers in these industries were relatively low and therefore that competition could be expected to result in adequate service levels and market prices, Congressional action has been aimed primarily at reducing the regulatory barriers to market entry. See H.R. Rep. No. 96-1069 (accompanying H.R. 6418), 96th Cong., 2d Sess., at 3, in 1980 U.S. Code Cong. & Ad. News, at 2285; H.R. Rep. No. 95-1211 (accompanying H.R. 12611), 95th Cong. 2d Sess., at 4-5, 1978 U.S. Code Cong. & Ad. News, at 3740-3741.

With regard to rate regulation, the Motor Carrier Act modified the administrative authority of the agencies primarily by creating zones of permissible rate increases or decreases for the carriers. Under the Motor Carrier Act, the ICC is prohibited, in certain circumstances, from investigating, suspending, revising, or revoking any rate falling within certain percentage guidelines on grounds that the rate is unreasonably high or low, 49 U.S.C. §10708(d)(1). Except as to rate increases falling within such zones of reasonableness, the ICC's power of rate investigation and suspension remained whole. 49 U.S.C. §10708(d)(4).

The Airline Deregulation Act established a scheme of gradual decontrol of airline rates. During the period of transition to decontrol, which ended January 1, 1983, the Civil Aeronautics Board retained rate authority. 49 U.S.C. §1551 (a)(2). Thus, the Airline Deregulation Act is perhaps less analogous as a model for continuing partial regulation; on the other hand, its usefulness is enhanced as a potential model for structuring regulatory authority during a period of transition to some form of decontrol of the oil pipeline industry.

Though the formula was more complex, the transitional rate authority of the CAB was similar to that of the ICC insofar as it established zones of reasonableness for rate changes by carriers with less than 70% market share over the relevant route. 49 U.S.C. §1482(d)(2). Whereas the zone of reasonableness in the Motor Carrier Act is based on a carrier's prior rates, under the Airline Deregulation Act, the zone of reasonableness for airline rates was based on the so-called "standard industry fare level," which was determined by reference to 1977 rates as adjusted semiannually by the CAB on the basis of "actual operating cost per available seat mile." 49 U.S.C. §1482(d)(6). Further, the Airline Deregulation Act allowed a 5% upward deviation, and a 50% downward deviation, from the CAB established levels, as compared with a 10% deviation from prior rates allowed under the Motor Carrier Act. The Airline Deregulation Act also set out various policy criteria to be used by the CAB in carrying out it rate-making functions, 49 U.S.C. §1482(e), but its basic powers to prescribe rates, 49 U.S.C. §1482(d)(1), and to suspend rates, 49 U.S.C. §1482(g), were not repealed during the transition period.

The usefulness of the Motor Carrier Act of 1980 and Airline Deregulation Act of 1978 as models for deregulation of oil pipeline rates therefore may be limited. Unlike motor carriers and airlines, oil pipelines have never been subjected to a pervasive regulatory scheme. In particular, oil pipeline companies have never been required to apply for certificates of public convenience and necessity before construction or extension of their systems. Accordingly, oil pipeline companies have not been subject to administrative competitions to obtain exclusive or semi-exclusive routes. Similarly, pipeline companies have not been subject to any direct restrictions on their right to abandon service. Consequently, they have not been compelled to subsidize unprofitable routes with the proceeds from profitable ones.

Turning back to other questions, I was asked whether identical prices to affiliate-shipper and to independent shippers would constitute a non-discriminatory rate under the language of H.R. 4488, all other conditions of service being equal. As your letter points out, the proposed legislation gives no guidance as to the interpretation of this language. The decision as to whether a rate is discriminatory is always a complex one, since rates are seldom prima facie discriminatory but may be so in the context of the terms and conditions of service with which they are associated. Factors such as the credit terms offered shippers, dividend payments, investment capital, as well as the physical aspects of capacity availability, storage, and transmission are only a few examples that illustrate the extent to which rates and services are so intertwined as to preclude viewing either in isolation. The potential for flexibility in the intepretation of H.R. 4488 suggests that Congress may not wish to address directly the outcome which is intended by such a provision or whether such matters should be left to develop through the decisions of the Federal Energy Regulatory Commission and the courts.

Most of the remaining questions in your letter of March 24, 1982, were either answered in my testimony of May 10 before the Subcommittee on Fossil and Synthetic Fuels or concern matters of antitrust policy. On these latter issues, I defer at this time to the expertise of the Department of Justice which, I understand, is prepared to fully address their implications. The final question which was not dealt with in my testimony was 20. It asked which of certain oil pipeline regulation functions are repealed by Section 4(a) of H.R. 4488. Those functions are listed in the Joint Explanatory Statement of the Committee of Conference in its discussion of the transfer of authority over oil pipelines was made from ICC to DOE. Of the ten functions described in the Conference Report, functions (1) and (5) are affected:

> (1) The pipeline's duty to ...establish...just and reasonable rates, fares, charges ...[Section 1(4), (1(5)]
>
> (5) The authority of the ICC to review all pipeline rates and, if it determines that a rate is unjust and unreasonable, or unjustly discriminatory or unduly preferential, to suspend such rate and determine the just and reasonable rate [Section 15(1) and 15(7)]

The conference report does not contain a list of all pipeline functions. A complete list of those sections of the Interstate Commerce Act which would appear to be repealed by H.R. 4488 follows:

Section 1(4) insofar as it deals with rates
Section 1(5)(a)
Section 13(4) insofar as it authorizes the Commission to prescribe rates
Section 15(1), 15(3), 15(6), 15(7) and perhaps 15(15) in that it deals with allowances which are in effect negative adjustments to rates; and
Section 65(a).

Finally, let me turn to the questions informally presented to the Commission staff:

1. I believe all witnesses indicated that more pipeline rates would decrease than would increase if there was total deregulation. Would you explain what aspect of current regulation is preventing any rates from being decreased? Why would pipelines who are presently unwilling to decrease rates become willing to do so under the proposed legislation or total deregulation? Would you also explain why so many pipelines are apprently interested in supporting legislation which would result in their tariffs being reduced?

In my testimony of May 10, I did not speculate upon the reaction of rates to decontrol of pipelines. Unfortunately, I am not aware of any empirical data which might provide guidance in the area.

2. If as claimed by the pipelines they are the most safe, environmentally sound and cost effective means of transporting petroleum and petroleum products, would you please explain how any other means of transportation could compete effectively?

While I do not venture any opinion upon the claims of the oil pipelines, it does appear that large segments of the petroleum transportation industry are competitive. As I stated in my testimony, pipelines compete among themselves, with tankers and barges along waterways, and when short distances are involved, with trucks. Objective analysis of the market conditions may soon be available which will enable us to conclude with more specificity the type and extent of competition which does exist.

3. Do you believe that tariffs have different effects upon owner/shippers than upon non-owner/shippers? If the tariffs were unjustly discriminatory or unduly preferential or prejudicial, would your answer be the same or different? Please explain.

I addressed the issues of discrimination against independent shippers in my statement filed with the Subcommittee on Fossil and Synthetic Fuels on May 10 and earlier in this letter. I respectfully refer you to pages 3-5 and 13-14 of the former and pages 2-4, 24-27 of this letter.

4. One of the avowed purposes of the proposed legislation is to encourage additional investment in new pipelines. Is there a similar purpose in what I understand to be the administration proposal of complete deregulation? Please identify as many examples as you can of pipelines which you expect to be built for the purpose of competing with a parallel pipeline or pipelines.

I believe that, to date, the Administration has not favored complete decontrol, nor am I aware of the extent to which attitudes about future investment in oil pipelines may have shaped the Administration's partial deregulation position. Oil pipelines have been regulated for the greater part of this century, and it is unlikely that there exists any clear empirical basis for projecting pipeline behavior in a deregulated environment. However, as I stated earlier in this letter, at 4, common sense would suggest that decontrol may encourage greater investment by reducing the risk that regulatory restraints would prevent a pipeline from earning a competitor rate of return on the investment.

5. The proposed amendment to the bill states: "Where the Commission has found that a rate is or will be unjustly discriminatory or unduly preferential or prejudicial, the Commission is authorized and empowered to make an order that the carrier or carriers shall cease and desist from such violation to the extent to which the Commission finds that the same does or will exist ..." Is it your understanding of the proposed amendment that with respect to rates the Commission is not authorized or empowered to determine and prescribe what rate would be just, fair and reasonable? Can you envision under the proposed bill with the amendment what types of relief would be available to a complaining shipper under an order of the Commission to cease and desist? Is there any way the Commission would be able to prohibit the pipeline from merely establishing new rates which might also be unjustly discriminatory or unduly preferential and prejudicial and require the complaining and adversely affected shipper to go through the whole administrative hearing process again? and again? Do you have any idea how long it should take for such a hearing process to reach a final result?

Before attempting to answer this question, it should be noted that neither I nor the Commission staff has been shown a copy of the "proposed amendment" quoted in your question. Apparently, the proposal has not been reduced to a formal amendment. To the extent that you have quoted the proposed amendment, its purpose appears to be to clarify the impact of the bill on the Commission's remedial powers. In essence, it specifies that the Commission shall have the power to issue a cease and desist order upon finding a pipeline company's rate to be discriminatory. The ICA presently provides the Commission with such power. Section 15(1), 49 U.S.C. §15(1), states:

> Whenever, after full hearing, ... the Commission shall be of opinion that any individual or joint rate, fare, or charge whatsoever demanded, charged, or collected by any common carrier or common car carriers ..., is or will be ... unjustly discriminatory or unduly preferential or prejudicial, ... the Commission is authorized and empowered ... to make an order that the carrier or carriers shall cease and desist from such violation to the extent which the Commission finds that the same does or will exist ....

As discussed above, the present text of H.R. 4488 could not reasonably be construed to affect the Commission's authority to issue cease and desist orders to cure violations of the ICA. Thus the proposed amendment seems to be unnecessary and would be, if adopted, merely redundant.

Your question, however, does not appear to be concerned exclusively with the potential effect of the proposed amendment, but with the broader question of whether H.R. 4488 would leave the Commission with adequate authority to deal effectively with violations of the ICA, and particularly with violations of sections 2 and 3 of the ICA, 49 U.S.C. §§2 and 3, which concern advantages and discriminations. This is a concern which is addressed in part above. See pages 7 to 18, supra. I noted there that H.R. 4488, so far as its purpose is simply to relieve oil pipeline companies of the duty to charge just and reasonable rates, ought to operate primarily on section 1(5), where the duty to charge just and reasonable rates is established, rather than section 15, which is designed primarily to set out the Commission's remedial powers. For this reason, H.R. 6815 represents, technically speaking, a better approach to legislating rate deregulation. Its impact more clear.

Whether H.R. 4488, with or without the proposed amendment, would leave the Commission with sufficient remedial power to deal with discriminatory rates requires consideration of the scope of its "cease and desist" authority without its current authority "to determine and prescribe." Obviously, the FERC, which has administered the ICA only since 1977, has had little practical experience with its remedial power under the ICA, and no experience with such power as it would be circumscribed by H.R. 4488. It appears, however, that the ICA, until 1906, was limited to the issuance of cease and desist orders and that Congress vested the ICC with the authority "to determine and prescribe" to correct the remedial weakness of the bare "cease and desist" authority which had been provided in the original act. An Act to Regulate Commerce, Feb. 4, 1887, ch. 104, §15, 24 Stat. 384. This weakness became apparent through a series of Supreme Court decisions, known as the Maximum Rate Cases, 17/ in which the Court refused to allow the ICC to use its "cease and desist" powers as a means of affording prospective relief. The essential theory of these cases was that the determination of whether a rate was unreasonable, unjust, discriminatory and/or advantageous would depend upon the circumstances of the case. Thus, what may have been determined unlawful for the past, might be lawful for the future. In the Court's view, to have granted the ICC the power to fix rates, or to set maximum rates, would have amounted to the granting of a "legislative power," and the Court found no evidence of such Congressional intent in the authorization of the ICC to require carriers to cease and desist. As a practical matter,

---

17/ Interstate Commerce Comm. v. Alabama Midland Ry. Co., 168 U.S. 144 (1897); Interstate Commerce Comm. v. Cincinnati, New Orleans & Texas Pacific Ry. Co., 167 U.S. 479 (1897); Cincinnati, New Orleans & Texas Pacific Ry. Co., v. Interstate Commerce Comm., 162 U.S. 184 (1896).

the primary enforcement mechanism under these decisions would have been shipper suits for "reparations." 18/ In 1906, Congress responded to the decisions in the *Maximum Rate Cases* by passing the Hepburn Act, which included a provision giving the ICC the authority to determine and prescribe maximum rates. Act of June 29, 1906, ch. 3591, §4, 34 Stat. 589-590. 19/

Whether courts today would construe the "cease and desist" power so narrowly as the Supreme Court did in the *Maximum Rate Cases* is unclear. The primary modern example of an agency which has been vested with cease and desist authority without more is the Federal Trade Commission under Section 5 of the Federal Trade Commission Act, 15 US.C. §45(b). 20/ Though orders under Section

---

18/ *See* 49 U.S.C. §13(1). In general, the statute of limitations on such actions is two years. 49 U.S.C. §16(3). One of your questions is how long it might take to conclude such a proceeding. The answer is that it is impossible to predict. It would depend on the complexity of the case, the degree of cooperation by the parties, and many other factors. It is clear that the process could frequently take more than 2 years.

19/ The authority to prescribe minimum rates was added by the Transportation Act of 1920. *See* Skinner & Eddy Corp. v. United States, 249 U.S. 557, 564-568 (1919) (discussing the legislative history of section 15). *See also* Interstate Commerce Comm. v. Humboldt Steamship Co., 224 U.S. 474 483 (1912) (holding that Hepburn Act granted ICC authority to determine and prescribe rates).

20/ Other agencies and offices which have been given "cease and desist" authority include, *e.g.*, the Federal Communications Commission, 47 U.S.C. §205(a), §312(b), the National Labor Relations Board, 29 U.S.C. §160(c); the Commodities Futures Trading Commission, 7 U.S.C. §§13a and 13b; the Federal Deposit Insurance Corporation, 12 U.S.C. §1730(e); the International Trade Commission, 19 U.S.C. §1337(f); the Federal Labor Relations Authority, 5 U.S.C. §7105(g)(3); the Assistant Secretary of Labor for Labor Management Relations, 5 U.S.C. §7120(d); the Foreign Service Labor Relations Board, 22 U.S.C. §4107(c)(2)(E); the Secretary of Agriculture, 7 U.S.C. §§193(b), 211(b), 211(c), 213(b), 1599(b), 2149(b), 2568(a), and 3804(b); the Commissioner of Education, 20 U.S.C. §1234c(c). Note that clear comparisons are difficult to draw as many of these provisions are attached to statutes which explicitly grant the administrative agency the authority to fashion "affirmative" relief. *See, e.g.*, 12 U.S.C. §1730 (stating that "the cease-and-desist order may, by provisions which may be mandatory, or otherwise, required... affirmative
(footnote continued)

5 "should go no further than reasonably necessary to correct the evil," Federal Trade Commission v. Royal Milling Co., 288 U.S. 212 (1933), and must bear a "reasonable relation" to the unlawful practices found, Standard Oil Co. v. Federal Trade Commission, 477 F.2d 653 (9th Cir. 1978); Speigel Inc. v. Federal Trade Commission, 411 F.2d 481 (1967), it has been held that the statute affords the FTC "wide discretion" in its "choice of remedies," Federal Trade Commission v. Cement Institute, 333 U.S. 683 (1948), reh. denied, 334 U.S. 839, and in the "type of order" it may issue. Atlantic Rfg. Co. v. Federal Trade Commission, 381 U.S. 357 (1965). Further, the order may be "broad and inclusive enough to stop the practices for all time," Eugene Dietzger Co. v. Federal Trade Commission, 142 F.2d 321 (1944), cert. denied 323 U.S. 730, and may prohibit the use of "related and similar practices." Niresk Industries, Inc. v. Federal Trade Commission, 278 F.2d 337 (1960), cert. denied 364 U.S. 883. In Luria Bros. & Co. v. Federal Trade Commission, 389 F. 2d 847 (1968), cert. denied 393 U.S. 829, the Third Circuit rejected an attempt to characterize an FTC order as an "affirmative order," and observed that an affirmative order would not in any case be invalid.

The cease and desist provisions of the National Labor Relations Act and the Federal Communications Act have been treated like Section 5 of the FTC Act. In National Labor Relations Board v. Express Publishing Co., 312 U.S. 426 (1941), the Supreme Court stated that the Board is free to restrain practices which "bear some resemblance" to the violation found. In the Matter of Terrance Noonan, 67 F.C.C. 2d 62 (1977), the FCC followed Express Publishing, holding that the cease and desist authority granted under the Federal Communication Act authorized it to prohibit conduct "persuasively related to that misconduct which occurred in the past." In short, the modern trend is toward viewing agency authority to issue cease and desist orders as comparable to a court's power to provide equitable relief. In the absence of other legislative guidance, I would tend to view the cease and desist power of this Commission

---

(Footnote continued)

action to correct the conditions resulting from any such violation or practice"). Furthermore, most of these agencies do not regulate rates. To the extent that they do, they have been given additional remedial powers. See, e.g., 47 U.S.C. §205(a) (FCC may determine and prescribe rates); 7 U.S.C. §211(a) (Secretary of Agriculture may determine and prescribe rates for stockyards). In general it appears that agencies with rate regulation functions are given the power to determine and prescribe rates. See, e.g., 15 U.S.C. §717d (fixing of rates under Natural Gas Act by FERC); 46 U.S.C. §845a (fixing of rates by Federal Maritime Commission); 49 U.S.C. §1482(d) (fixing of rates by Civil Aeronautics Board).

under the ICA as analogous to that of the FTC, the NLRB, and the FCC, as set out above. Such a construction would seem to be imperative if the Commission is to accomplish its assigned regulatory mission effectively and efficiently. These judicial decisions, however, must be balanced against the legislative history surrounding any amendment of the ICA. Accordingly, it may be appropriate that the Subcommittee carefully evaluate and define the remedial powers which are to be delegated or withdrawn from the Commission, including (1) whether the FERC shall be authorized to determine and prescribe future rates and practices; (2) whether the FERC shall have the power to issue affirmative orders to correct conditions which have resulted from violations; (3) whether the FERC shall have the power to prohibit violations which have been discontinued prior to the issuance of an order, but are likely to recur; 21/ and (4) whether the FERC shall have the power to prohibit violations which are related and similar to those found.

I hope that the foregoing and the enclosed bibliography are both helpful and responsive to your request. If I or the Commission staff can be of further assistance to you in this matter, please do not hesitate to call on me.

Sincerely,

C. M. Butler III
Chairman

Enclosure

21/ In this regard the Subcommittee should note that Section 15(1), as well as the proposed amendment of H.R. 4488, states that the FERC may prohibit a violation so far as it finds that it "does or will exist." Although there appears to be no authority on point, that language could be construed to invalidate Commission orders where the violative practice is "voluntarily" corrected before the Commission has had the opportunity to act. This method of regulatory evasion is comparable to that posed in your question, and would compound the problem of effective regulation.

Bibliography On Oil Pipeline Regulation
Topical Listing
August 1982

Government Material

Relevant Legislation

Interstate Commerce Act. 49 United States Code (1887). Recodified without substantive change 92 Stat. 1337, 49 U.S.C. 10101 *et seq.* Revised Interstate Commerce Act, Pub. L. 95-473.1978.

The ICA requires:

1) Every common carrier must provide transportation upon reasonable request and establish through routes with other carriers. S.1(4).

2) Oil pipelines to serve as common carriers. S.1(3)a

3) Every common carrier must file tariff schedules, S. 6(1), establish just and reasonable rates, S.15(1), and cannot make unreasonable preference or advantage, discriminate in price to lessen competition, or grant rebates. S.3,2, and the Clayton Act.

The Elkins Act amendment to sections 41-43, 32 Stat. 847 1903, established criminal penalties for failing to comply with tariff filing procedure and for offering or receiving rebates. Fines for noncompliance were stated as treble the amount of the rebate.

Hepburn Act. 34 Stat. 1906

The Hepburn Act extended common carrier status and federal regulation under the ICA to oil pipelines. Pipelines were not required to separate their service from oil transported which they owned.

Deepwater Port Act of 1974, 33 United States Code

This act pertains to the use of deepwater ports for oil transhipment and forbids licensing which would create adverse affects on competition contravening antitrust law.

Department of Energy Organization Act. 42 United States Code 1977.

This Act transferred oil pipeline regulation to the FERC from its previous responsibility under the ICC. ss. 402, 642.

Department of Energy Delegation Order 0204-1.

This Order assigned FERC all statues formerly resting with the ICC relating to oil pipelines (except Section 11 of the Clayton Act).

U.S. Congress

United States Temporary National Economic Committee. Investigation of Concentration of Economic Power. Monograph 39."Control of Petroleum Industry by Major Oil Companies". Roy C. Cook, Antitrust Division, Department of Justice. 76th Congress. 3d session. Government Printing Office. 1940.

House Committee on the Judiciary. Subcommittee on Antitrust. Consent Decree Project of the Department of Justice. 86th Congress. 1st session 176. 1959.

House Committee on Interior and Insular Affairs. Subcommittee on Public Lands. Oil and Natural Gas Pipeline Rights-of-way. 1973. 93d Congress. 1st Session.

House Judiciary Committee. Subcommittee on Monopolies and Commercial Law. Hearings on Oil Pipeline Competition. September 10, 1975.

National Energy Transportation Vol. I, Current Systems and Movements. Pub. No. 95-15. Senate Energy and Natural Resources Committee. Subcommittee on Commerce, Science and Transportation. 95th Congress. 1st session. May 1977. (1980 revised)

House Committee on the Judiciary. Subcommittee on Antitrust & Monopoly. Oil Company Ownership of Pipelines. 1978. 95th Congress. 2nd Session.

Senate Staff Report

Includes a summary of the history behind regulation of oil pipelines and attempts at divestiture. Claims that the Interstate Commerce Act is inadequate to deal with pipeline company dual ownership and urges FERC to devote attention to resolving the shipper/owner controversy.

Testimony of John Shenefield, Department of Justice

Shenefield presents a brief overview of the oil pipeline industry and regulation. He examines monopoly characteristics in economic terms and then applies these to oil pipelines with a thorough presentation of the Justice theory of throughput restriction. He concludes with an assessment of divestiture, its goals and affects on social welfare.

House Committee on Energy and Commerce Subcommittee on Fossil and Synthetic Fuels. Rate Regulation for Petroleum Pipelines. March 31, 1982.

Department of Energy

Crude Petroleum, Petroleum Products, and Natural Gas Liquids. 1980 (final). EIA-108 (80).

Department of Justice

J. Schenefield and J. Sims. Statement of Factual Position of the Department of Justice, before the Office of Hearings and Appeals. No. 2 Home Heating Oil Hearings. June 30, 1978.

Report of the Antitrust Division, on the Competitive Implications of the Ownership and Operation by Standard Oil of Ohio of a Long Beach California - Midland Texas Crude Oil Pipeline, June 1978. In Mitchell, Oil Pipelines and Public Policy. Supplement 2. p. 217.

> The Justice Department analyzes the SOHIO pipeline from California to Texas. They conclude the right-of-way should be granted, since the pipeline would not result in "anti-competitive" behavior. The competitive analysis of the pipeline includes a discussion of natural monopoly, economies of scale, and a complete market review of oil supply conditions in Petroleum Administration Districts II, III and V; Arizona, New Mexico, and California. Although the pipeline would be the only carrier, the Justice analysis conceded in this case because the potential victims of market control are also the owners of the pipeline.

"Report of the Attorney General on the Applications of LOOP and Seadock for Deepwater Port Licenses," Nov. 5, 1976.

> The Department of Justice offers a set of "competitive rules" for regulation of oil pipelines. These are nondiscriminatory access, automatic expansion rights for pipelines with adequate throughput at standard tariff rates, open ownership of pipeline facilities, and annual revision of ownership shares. These are intended to increase competition to prevent constrained oil shipments, and to equalize owned shares with the amount of average throughput.

"Report of the Attorney General Pursuant to Section 19 of the Alaska Natural Gas Transportation Act", July 1977.

> Report in which Justice Advances their undersizing theory of oil pipeline monopoly, and extends it to

natural gas, deepwater ports and coal transportation. The Department makes conclusions about excessive pipeline profits from high marginal costs, and concludes that the ANGTS pipeline provides the same potential for monopoly pricing as oil pipelines. The study further concludes that prorationing is a symptom of pipeline capacity restriction.

Report of the United States Department of Justice. "Antitrust Advice on the License Application of the Texas Deepwater Port Authority", pursuant to Section 7 of the Deepwater Port Act of 1974. July 1979.

Justice concludes after an economic analysis that there is no anticompetitive effects from the proposed Texas Gulf port. They recommend licensing with several restrictions on membership and operations to avoid shipper capacity restriction or discrimination. The Report also contains an antitrust review and comments on the TDPA two-tier tariff.

Interstate Commerce Commission

Valuation of Common Carrier Pipelines. 243 ICC. 1940.

In this case the ICC recognized that oil pipeline companies were controlled by their parent company, and that rates were not being set with a view to costs of service. In fact they were being set with regard to available benefits for the controlling company. These facts, however, were deemed immaterial for the setting of rates.

Reduced Pipeline Rates and Gathering Charges. 243 ICC 115. 1940.

Petroleum Products, Williams Brothers Pipeline Co. 351 ICC 102. 1975

Williams Brothers Pipeline Co. 355 ICC 479. 1976. Final Decision by the Commission.

Transport Statistics in the U.S. 1976.

Federal Energy Regulatory Commission

Invitation to Submit Comments on Ratemaking Principles for Oil Pipeline Rate Cases, Docket No. OR79-1. April 11, 1975.

Valuation of Common Carrier Pipelines. Docket No. RM-78-2.
March 25, 1977. (formerly ICC Ex. Parte 308)
Testimony of Jesse C. Oak. Bureau of Accounts. ICC.

> Oak discuss the Valuation Act and requirements for ICC (now FERC) records and statistics on valuations of common carriers. This act was updated by an ICC General Order in 1959. Oak's testimony is the first public discussion of the ICC methods for computing valuation.

Statement of Views and Arguments by the U.S. Department of Justice.

> Justice presents their capacity restriction theory of pipeline competition. They further show how even with nondiscriminatory access, integrated companies can reap profits at downstream unregulated stages through pipeline sizing. There is also a discussion of original costs versus valuation ratemaking, plus profitability data on pipelines.

Williams Pipeline Co. Proceeding. Docket No. OR79-1.

> This case of over 10,000 pages includes testimony from members of every interested area; the FERC, ICC, Justice, industry and state government.

Order Scheduling A Consolidated Oral Argument and Prescribing Procedures Therefore. Docket No. OR79-1,78-1. May 9, 1980.

Federal Trade Commission

Prices, Profits and Competition in the Petroleum Industry, 1928.

Petroleum Administration for Defense

Transportation of Oil, December 1951.

General Accounting Office

Petroleum Pipeline Rates and Competition: Issues Long Neglected by Federal Regulations and In Need of Attention. July 13, 1979 EMD-79-31.

United States Supreme Court

FPC vs. Hope Natural Gas. 320 US 591. 1944.

This is the case in which the fair value ratemaking method was disavowed. The judge espoused some form of cost-based rate for natural gas pipelines. The case also held that due process requires that a public utility be allowed to collect a reasonable rate of return on its investment. Hope was cited as precedent in the Justice action to vacate the Consent

U.S. vs. Champlin Refining Co. 341 U.S. 290,297.1951.

In Champlin the court stated that the ICA and Congress had the express intent to "eliminate the competitive advantage which companies might possess from the exclusive ownership of a pipeline."

U.S. vs. Atlantic Refining Co. 360 U.S. 19. 1958.

The court indicated that modifying the Elkins Act Consent Decree would be appropriate.

Lone Star Steel vs. McGee. 380 F. 2d, 640,646. 5th Cir. 1967.

In Lone Star the court rejected the steel company's definition of rail service as "plant facility". The court decided that the criteria to examine was the substance, not form, of the service and the relationship of the service to the other operations of the company. Since the services were "in connection" with an interstate common carrier, the services were included in regulatory jurisdiction as a common carrier.

Williams Pipeline Co. vs. FERC 439 U.S. 995. 1978.

United States Circuit Court

U.S. vs. Atlantic Refining. Civil Action 14060. 1941.

The Atlantic case was where the original Elkins Act Consent Decree was first entered. The Decree limited pipeline companies with parent operatives from paying the shipper/owners dividends in excess of 7% of the pipeline valuation.

Farmers Union Central Exchange vs. FERC. 584 F. 2d.408. DC Cir. 1978.

> The Supreme Court refused to hear the appeal cert. denied sub nom. Williams Pipeline Co. vs. FERC, 439 U.S. 995. The circuit court gave FERC a mandate to begin its pipeline authority taken over from the ICC on a "clean slate".

Statement of Points and Authorities in Support of Motion to Vacate, U.S. vs. Atlantic Refining Co. filed November 16, 1981.

> Here Justice argues that the original theory of the anticompetitive nature of dividend payments was unsound. They also argue, somewhat inconsistently, that the Decree was ineffective in its application.

Other Sources

W. Beard, Regulation of Pipelines as Common Carriers, ________, __________. 1941.

R. Cassady, Price Making and Price Behavior in The Petroleum Industry. New Haven: Yale University Press. 1954.

Coburn, Leonard. Pipeline Transportation: A Review of the Oil Pipeline Industry. 1976.

Cookenboo, Leslie. Crude Oil Pipelines and Competition in the Oil Industry. New York: Arno Press. 1952.

Delaney, Fenili & Field. The State of Competition in Gasoline Marketing. 1981.

> Includes analysis showing that profits from upstream markets have not been used to subsidize gasoline marketing.

T.D. Ducheson, Competition In the US Energy Industry: A Report to the Energy Policy Project of the Ford Foundation. Cambridge: Ballinger. 1975.

Fleming, Harold. Oil Prices and Competition. New York: American Petroleum Institute. 1957.

Hamilton, Daniel C. Competition In Oil. Cambridge: Harvard University Press. 1958.

> Hamilton undertakes a comprehensive study of competition in crude oil refinery in the Gulf Coast region.

His discussion covers the competitive structure of the industry; price history and operation, entry and exit, concentration ratios and access to product markets. There are brief discussions of pipelines with regard to refiner access to crude and transportation of finished product. Hamilton concludes that for the Gulf Refineries, non-competitive pipeline operation has not resulted in noncompetitive refinery operation. The author studies the market from 1925 to 1950, and concludes that the ten years of effective common-carrier status, proferred on integrated pipeline companies by the Hepburn Act, The Pipeline Cases of 1914, and the Consent Decree, gave the refinery markets sufficient time to develop in a free access market. He further states that refineries in the Gulf need no access to major trunk lines because of product availability in the region. Refiners in general are located in tidewater regions with alternate modes of transporting products.

J. Hansen, *Competitive Aspects of the U.S. Petroleum Pipeline Industry: Implications for Regulatory Policy.* Dissertation for Yale University. 1980.

Hansen draws conclusions on pipeline competition in the nation through this study of 39 refinery crude and product markets. He compares market operations and available water transportation for refineries with capacity greater than 50,000 barrels per day, and assesses competitive characteristics and alternate market service available (other than pipeline). Coburn criticized this study for neglecting to use capacity data in the crude market to study concentration ratios. Hansen *does* study concentration as well as water access in the refinery product market. He concludes that the markets are competitive in spite of high concentration ratios because of alternative service on inland water and highly competitive product markets. An important discussion in Hansen is his profitability study, which is a valuable look at returns to total capital of pipelines.

A. Johnson, *Petroleum Pipelines and Public Policy: 1906 -1959.* Cambridge: Harvard University Press. 1967.

A. Johnson, *The Development of American Petroleum Piplines.* ________:______. 1956.

W. Jones, *Authority of the Department of Energy to Regulate Anticompetitive Aspects of Petroleum Pipeline Operations.* Department of Energy. 1978.

R. Levy. The Regulation of Offshore Crude Oil Pipelines and the Consequences for Competition. National Science Foundation. Office of Energy Research and Developmental Policy. August 1975.

J.G. Mclean, and R.W. Haigh, The Growth of Integrated Oil Companies. Norwood, Mass:Plimpton Press. 1954.

Mitchell, Edward J. Vertical Integration in the Oil Industry. ______,______. 1976.

Mitchell, Edward J. Oil Pipelines and Public Policy. American Enterprise Institute. Washington D.C. 1979. (articles cited separately).

J. Piercey, The Pipeline Segment of the Domestic Petroleum Industry: Structure and Conduct. University of Oklahoma. 1978.

M. Piette, The U.S. Petroleum Pipeline Industry: A Study of Vertical Integration. Florida State University. 1977.

F. Scherer, Industrial Market Structure and Economic Performance. Chicago: Rand McNally. 1970.

> This is an economic analysis of U.S. industry, monopoly, mergers and competition. It includes theoretical discussion of monopoly and the basis for controlling markets. There are specific discussions on a wide range of economic topics, including (relevant to this bibliography) price discrimination, market efficiency, antitrust policy and regulation.

H. Williamson, The American Petroleum Industry. ______, ______. 1963.

G. Wolbert, U.S. Oil Pipelines. American Petroleum Institute. Washington, D.C. 1979.

Articles

M. Canes, and D. Norman, "Pipelines and Public Policy" in Mitchell, Oil Pipelines and Public Policy.

> This article details the Department of Justice capacity restriction theory. The authors criticize the theory on several levels, claiming inconsistent rationale and lack of empirical evidence. Justice seems to offer undersizing as a means of extracting monopoly profits in downstream markets, but simultaneously assumes adjaindustry markets are competitive

pipeline sizing. They further criticize Justices's use of prorationing as empirical evidence of undersizing. Prorationing, it is contended, can result from a variety of other sources, including fluctuating demand even in a world of competitive behavior. Finally, comments are offered on a few prospective resolutions to pipeline regulatory problems, divestiture, deregulation, and the Department of Justice "competitive rule".

Coburn, Leonard L. "Petroleum Pipeline Deregulation: A Competitive Analysis". U.S. Department of Energy. Office of Competition. Assistant Secretary for Congressional, Intergovernmental and Public Affairs. May 1982. Washington D.C. (56 pages)

Coburn makes a strong case for oil pipeline deregulation in this study. He initially reviews the characteristics of oil and oil shipping, and goes into a brief summary of the regulatory history; the Interstate Commerce Act and FERC rate regulation. The inference here is that rate-making on a basis of original cost would be desirable to the valuation method, but that problems with providing adequate cost returns make any regulation suspect. Coburn shows the benefits of regulation to be minimal. He explains that since transportation costs are a small part of wellhead prices, production and distribution gains in efficiency are slight. The costs of regulation, however, are said to be substantial, including administrative costs to government and industry, improper investor incentives produced by low rates of return, and inefficient operating methods by pipelines, who can pass through high costs. The paper further analyzes competition in oil pipelines, and concludes that the market has high concentration, but this is offset by relative freedom of entry. The final section of the study relates deregulation to the common carrier status of pipelines. Coburn believes that the fair rate of return on use of assets by owners of a pipeline who also ship oil, the "dividends" dealt with in the Elkins Act Consent Decree, are easily applicable under a deregulated system.

Erickson, Edward W., Gayle C. Linder and William L. Peters. "The Pipeline Undersizing Argument and the Record of Access and Expansion in the Oil Pipeline Industry." in Mitchell, Oil Pipelines and Public Policy. p. 15.

The authors critique the shell-game theory of movement between units of an oil corporation. They further examine ownership, access and entrance to the pipeline market between 1972 and 1977, to assess the credibility of the Department of Justice undersizing theory. This theory, the paper presumes would be borne out through limited access to pipelines of non-owner shippers.

Erickson, Edward W., and Robert M. Spann. "Vertical Integration and Cross-Subsidization in the U.S. Petroleum Industry: A Critical Review". North Carolina State University, Department of Economics, Economics Special Report. December 1977.

This is a study of the oil industry including crude production, refining, pipelines and marketing. The authors make conclusions on competitive aspects of the four sectors of the industry, and maintain that entry and expansion have involved small firms as well as larger corporations.

Exxon Co. USA. "Comments on John H. Shenefield's Pipeline Divestiture Testimony", preliminary draft. January 5, 1979.

D. Flexner. "Oil Pipelines: The Case for Divestiture", in Mitchell, Oil Pipelines and Public Policy. p.3.

Flexner examines the market structure of pipelines, the theory of natural monopoly and how it applies to oil pipelines. He advance a theory of pipeline competition contingent upon joint ventures and downstream market power. He further disputes prorationing as a remedy for the pipeline market and supports deregulation and structural relief as better solutions.

Kobrin, Paul. "A Formal Critique of the Justice Department's Undersizing Assertion". American Petroleum Institute, Policy Analysis Department. Critique no. 004. August 22, 1978.

Kobrin charges that competitive operation in stages of the industry adjacent to pipelines, also a Justice assumption, will cause competition among producers for access to the pipeline. Shippers will tender more oil for shipment, and the cost of access to the pipeline will rise, with the increased cost of any oil also shipped by tanker, the alternative service. At the same time, the delivered price of oil falls. Kobrin claims that shippers will tender additional oil to pipelines until profits are zero.

Malet, Edwin I. "Oil Pipelines as Common Carriers: Issues of Form and Substance". April, 1982. Houston Law Review. (to be published)

> Malet sees oil company integration as a non-competitive process which confers undue preferences on the companies. He analyzes the peculiar irony of regulation which fails to provide for an industry that is vertically integrated. Malet determines that the regulatory intent of the ICA, Hepburn Act and subsequent cases provides for unlawful competitive advantage through shipper/owner activities and other corporate "veils" to maintain integration. Malet decides it is within FERC's authority to assess the variability in ownership of pipelines by major oil companies, their organization, and the nature of common carrier status.

R.B.Mancke. "Competition in the Oil Industry". in Mitchell, Vertical Integration

McCullough, Douglas L. "Implications of Divestiture.(summary version)". U.S. Department of the Treasury. Staff Task Force on Energy Industry Divestiture. June 1976. Washington D.C. (44 pages)

> This study is a Treasury Department response to two pieces of legislation presented to Congress in 1975. The bills, both in the Senate, proposed (separately) vertical and horizontal divestiture of major oil companies. The study presents a review of the domestic and world energy industry, with statistics on production and concentration ratios. It goes on to assess the implications of divestiture on the finances, energy supply and demand, and planned investment of oil companies. The study concludes with remarks on the effects of such legislation on the economy, the international energy market, and on United States energy objectives. The report briefly examines the effect on the pipeline portion of the industry. It concludes that existing patterns of oil flow, under oil exchange agreements in many cases, will continue under a vertically divested regime. Since pipelines are regulated as common carriers, Treasury concludes that the quantity and quality of regulation must be altered if the pipelines are to gain competitive character. The overall conclusions are that because of long lead times, investor uncertainty, increased risk and decreased

supply due to inefficient production and decreased attention to R&D activities, the effects of divestiture on U.S. energy needs and the general economy would be undesirable.

Mead, David E. "Exxon Paper on TAPS' Deregulation". Memo to Robert Means, Director, Office of Regulatory Analysis. Federal Energy Regulatory Commission. October 27, 1981.

This paper presents an analysis of two contentions made by Exxon in a paper on the deregulation of the Trans Alaska Pipeline. Mead rejects both arguments: (1) that returns to capital under the Consent Decree are below most other rates of return in the economy and (2) that there is significant competition among the eight owners of TAPS.

Mead, David E. "Background Information Relating to Oil Pipeline Deregulation". Office of Regulatory Analysis. Federal Energy Regulatory Commission. September 1981.

This analysis was prepared for Alaska's Senator Murkowski. It contains a review of the Alaska pipeline and tax and tariff provisions which suggest that the TAPS be excluded from oil deregulation proposals. The paper further analyzes rate of return issues and the Consent Decree, with a discussion of equity vs. debt financing. Finally, there is a discussion of the ICC valuation method, and two alternate methods, original cost and trended original cost.

Mitchell, Edward J. "Protection of Petroleum Refiners?" Regulation. July-August. 1981, p.41.

Mitchell, Edward J. "A Study of Oil Pipeline Competition" (unpublished paper) April 1982.

Mitchell looks at several aspects of the industry to conclude that pipelines exhibit significant competitive behavior. Among his justifications are: low concentration ratios, competition with other pipelines and with water transport, average profitability, and rate-of-return unconstrained by regulation.

Navarro, Peter and Thomas Stauffer. "The Legal History and Economic Implications of Oil Pipeline Regulation". Energy Law Journal 291, 1981.

Navarro, Peter, Thomas Stauffer and Bruce Peterson. "A Critical Comparison of Utility-Type Ratemaking Methodologies in Oil Pipeline Regulation". Bell Journal of Economics. ______________.

> The authors present an economic analysis of four methods of rate-of-return regulation: (1) ICC valuation (2) Consent Decree (3) FERC utility formula and (4) escalated utility rates. Each is discussed with regard to bias disproportionality, and further compared to a normative standard, "levelized real rates".

R. A. Prewitt. "The Operation and Regulation of Crude Oil and Gasolilne Pipelines". Quarterly Journal of Economics. LVI 1942.; p. 177-211.

Spavins, Thomas C. "The Regulation of Oil Pipelines". in Mitchell, *Oil Pipelines and Public Policy*. p.77.

> Spavins makes an analysis of the pipeline market and concludes it is anticompetitive. He presents data for 1975 to 1977, showing petroleum pipelines enjoying high returns on capital relative to other industries and competing markets. Spavins opposes deregulation of the industry, and contends there is no reasoned regulation on pipeline profit, and no present standard for rate-making.

S.A. Swensrud. "The Relation Between Crude Oil and Product Prices". Bulletin of the American Association of Petroleum Geologists. XXIII. 1939 pp. 765-88

D. Teece. "Vertical Integration In the U.S. Oil Industry". in Mitchell, *Vertical Integration*.

Andrew E. Zimbler
Office of Regulatory Analysis
Federal Energy Regulatory Commission

Prepared by the Federal Energy Regulatory Commission
December 1982

FACT SHEET

U. S. OIL PIPE LINE INDUSTRY

FACILITIES

Mileage of Oil Pipelines - 1977

Crude trunk lines	77,972	
Crude gathering lines	67,798	
Product trunk lines	81,296	
Total		227,066
States in which pipelines operate		49

PERFORMANCE

Total tons of crude and products carried, 1980	921 million
Total ton-miles of crude and products, 1980	576 billion
Percent of total intercity freight carried by pipelines, 1981	22.4%
Percent of all crude oil and refined products transported that is carried by pipelines, 1980	46.2%

FINANCIAL

Capital investment in oil pipelines, 1981	$21.2 billion
Operating revenues, 1981	6.6 billion
Oil pipelines' share of nation's freight bill, 1980	3.3%
Tariff rate to ship one gallon of gasoline from Texas to New York by pipeline, 1981	1.8 cents

SAFETY

Oil pipeline fatalities (6) as percent of total transportation fatalities (53,496), 1981	.0112%

PRODUCTIVITY

Productivity (output per employee hour) average annual rate of change (1958-1979)	7.1%

ENERGY INTENSIVENESS (at capacity)

BTUS/ton-mile - 1978

Crude lines	322
Product lines	427

REGULATION AND EMPLOYMENT

Number of oil pipeline companies regulated by the Federal Energy Regulatory Commission	136
Total Employees in oil pipeline industry, 1981	21,900

Mr. **Anderson**. Please proceed.

TESTIMONY OF DR. ROBERT C. MEANS, DIRECTOR, OFFICE OF REGULATORY ANALYSIS, FEDERAL ENERGY REGULATORY COMMISSION, ACCOMPANIED BY LYNNE H. CHURCH, ASSOCIATE GENERAL COUNSEL, FERC

Dr. **Means**. Thank you, Mr. Chairman.

With me today is Lynne Church, Associate General Counsel of the Commission.

The Interstate Commerce Act, like virtually every public utility regulation act, provides for two different kinds of price regulation. A regulation of overall rate levels captured in the legal formula, just and reasonable rates, and a regulation of the relationship between one rate and another captured in references to undue discrimination.

H.R. 2677 would eliminate the first kind of rate regulation, but retain the latter, and I would like to comment very briefly on the two sides then of H.R. 2677.

With respect to the first, the elimination of regulation of overall rate levels, I would like to spend just a moment outlining what is at stake in that kind of rate regulation.

In contrast to natural gas pipelines, oil pipelines do not themselves buy and sell gas. They transport gas for a fee. That transportation fee then determines the difference between the price received by the seller and the price paid by the buyer.

For a crude oil pipeline, for example, if the producer sells his oil for $30 a barrel, and the transportation fee is 30 cents, then the refiner will pay $30.30 a barrel for the crude oil; similarly, for the transportation of oil refined products from a refinery to a wholesaler of gasoline, for example.

This suggests that one of two things may be at stake in regulating overall rates charged by oil pipelines. Either the amount received by the seller, or the amount paid by the buyer. Oil pipelines constitute overwhelmingly the most efficient way to move oil under most circumstances, and it is important that they receive the return that will encourage investment. To the extent that there is monopoly power, however, sellers of crude oil or refined products may receive less, or buyers of crude oil or refined products may have to pay more than is necessary.

For this to happen, however, it is necessary that there be monopoly power, that the buyer or the seller lack effective alternatives. Because of the nature of the industry, there are essentially two kinds of alternatives that may be available to them. One alternative is another way of transporting the oil, particularly another crude oil or product pipeline. But there are other kinds of alternatives that may be equally effective in limiting monopoly power of oil pipelines.

For example, if an oil producer can sell his oil to a local refinery, then there is no reason for him to accept a lower price transporting it through an oil pipeline to a distant refinery. He is effectively protected against exploitation by the oil pipeline, even if the oil pipeline is the only way of moving his oil, because he has the alternative of not having to move his oil.

Similarly, if a refinery is located on a sea coast, accessible by oceangoing tankers, then the price it will pay for crude oil is going to be effectively determined by the price of imported oil brought in by tanker. There is no reason for the refinery to pay a higher price for crude, even if the oil pipeline serving that refinery does have unlimited monopoly powers as a transporter of oil over land. The price that the refiner pays would be limited by the competition from the tanker.

There is a substantial measure of competition of one or the other of those two kinds with respect to the buyers and sellers of crude oil and refined products. However, there appears to be some areas in which competition alone may not be fully effective.

In assessing the implications of this, it is important to bear in mind, as well, that again in contrast to natural gas pipelines, the fees charged by oil pipelines for transporting crude and refined products tend to be very small in relationship to the final delivered price.

It is important not to compare imperfect markets with a perfect regulation that does not exist. The alternatives are the markets as they exist, with some imperfections, and a regulatory process that realistically cannot set the precise price that would be determined by perfect competition.

The practical question that has to be asked then is are the market imperfections large enough that an imperfect regulatory process is likely to be able to improve on the results of those markets.

In commenting very briefly on that, I would like to make it clear that I am discussing only the lower 48 States. TAPS is involved in litigation before the Commission, in which virtually every policy and legal issue is contested, and I cannot comment upon TAPS.

With respect to the lower 48, it is possible that there are some markets in which, indeed, some kind of regulation could improve on the markets. We will know, I think, considerably more about that when a study currently being conducted by the Antitrust Division of the Department of Justice is completed.

Based on informal discussions with members of the staff, it appears that it will, more than any preceding study, take into account the competition, not only from alternative transportation modes, and other oil pipelines, but also the competition that exists as a result of international trade in oil and refineries located close to markets, or close to the producing areas.

I am told that that study should be ready in the near future, but I believe Mr. Baxter will be testifying later this morning.

The second issue concerns rate design, and here there is, I think, some reason for concern. The concern stems from another characteristic of the oil pipeline industry, and that is that it is, for the most part, vertically integrated. Most oil pipelines are owned, or are affiliates of producers of oil.

A uniform high rate charged by an oil pipeline that is an affiliate of one of the crude oil producers that ships on it will have a different financial impact on the affiliated producer than it will on the independent producers that may also use the pipeline. For the affiliated producer, the decreased revenues to the producer are offset by increased revenues to the affiliated pipeline. There is no similar offset for the independent oil producer.

There are, under the legal provisions that would remain, under H. R. 2677, basically two alternatives. One alternative is that the provision dealing with discrimination might be interpreted not to cover the case of uniform high rates charged by an affiliated oil pipeline. In that case, there would be no protection for the independent producer.

The other alternative is that those same provisions would be interpreted to apply to the case in which there were uniform high rates that had a differential impact on affiliated and nonaffiliated oil producers. That would deal with the problem, but it would open up the integrated oil pipelines that constitute a majority of the industry to the potential of overall rate regulation under another name, because the only way that one could determine whether the rates were uniform, but excessively high, is to determine if they were excessively high, and that of course is precisely the question that H.R. 2677 has sought to remove from regulatory consideration by elimination of the rules relating to just and reasonable rates.

If the oil pipeline industry is indeed fully competitive to the point where regulation is unlikely to improve on the results of the market, then there is no need for legal rules limiting discrimination. Competition protects against discrimination, just as it protects against excessive rates.

If, on the other hand, there are pockets, markets, in which there is sufficient market power that continued regulation is justified, then there may be justification for protection against the kind of discriminatory rates that I just described, but then there may also be justification for regulation of the just and reasonable level of the overall rates.

Thank you.

Mr. ANDERSON. Thank you, Doctor.

On page 1 of your statement, you say "I want to make it clear that the opinion expressed in this testimony are mine alone and do not represent the view of the Commissioner or any individual Commissioner."

I assume from your statement that the Commission has no official opinion on the merits of this legislation, is that correct?

Dr. MEANS. That is right. For the Commission to have an official opinion, it would be necessary to—I am not even sure—the Commission has in the past taken positions on legislation but that would require a formal process by votes of Commissioners, and no such process has been undertaken here.

Mr. ANDERSON. Now, your testimony indicates that there may be some monopoly power in the oil pipeline industry. Please explain what you mean when you say monopoly power.

Can you give the subcommittee some indication of how widespread that monopoly power is?

Dr. MEANS. I can answer the first question. I cannot, I think—I can only give a very limited answer to the second part of that question.

With respect to the first question, monopoly power or market power is simply the power to set price. It constitutes the power of some freedom of choice over the price that is charged. Under perfect competition, no such power exists. Competition drives the price down to a level necessary to cover costs. If there is monopoly power, then it is possible for the seller of the service, here the oil pipeline, to charge a price above the one necessary to cover its costs, including a reasonable return on investment. If it can do so, then that difference between the price necessary to cover cost and the one actually charged is going to have to be reflected in either lower prices to the seller or higher prices to the buyer of the product transported.

With respect to the second question, we have now had at least three major studies. One by Hanson, who at one point worked for the office for which I now work; a study by Professor Mitchell and a study by NERA.

The last two were commissioned studies, and the results reached, not surprisingly, tended to reflect positions taken by the parties commissioning the studies. Nevertheless, I think that through the accumulation of those studies we have learned a great deal about oil pipelines. It is clear that monopoly power is limited in the oil pipeline industry. There are many markets in which there is competition. I think it likely that there is competition in one form or another in most markets. None of the studies to this point I think have had the data to assess all of the forms that competition may take. I think a much more precise reading on the extent of competition, and therefore on the extent of monopoly power, is likely to be possible after the Antitrust Division completes its study.

Mr. **Anderson**. Recently in the Williams Pipeline Co. case, FERC announced industry wide standards for testing the propriety of oil pipeline rates.

Could you explain that policy and how that policy differs from that followed by the Interstate Commerce Commission?

Dr. **Means**. In general terms, the policy could be described as having three elements. One is a determination of a rate base on what has come to be called the fair value methodology. That element is precisely the same, at least in basic form, as the one used by the Interstate Commerce Commission.

The second element is essentially a procedural element and it is that the process is one which will be essentially activated on protest by shippers; that likewise corresponds to the policy of the Interstate Commerce Commission.

The third element of the policy concerns the rate of return on that rate base. The Interstate Commerce Commission used a standard rate of return which had been determined, I believe, in 1940 and 1941 for the two basic kinds of pipelines of 8 percent and 10 percent with no determination of the rate of return from case to case. That element has been changed by the Williams case which contemplates that there would be a market rate of return adjusted downwards for the fact that the rate base itself will tend to increase with inflation.

Mr. **Anderson**. Under this new rate policy, do you anticipate that rates will increase or decrease?

Dr. **Means**. I would be surprised if there were significant increases over what would have occurred under regulation in most markets. If there are market increases, then shippers are free to protest. The fact of the matter is it is very difficult to assess that because the industry has in the past been subject to two different kinds of regulation. One is the one which we have taken over from the Interstate Commerce Commission; the other is a different form of regulation that was imposed by the Antitrust Division under the antitrust decree of 1940 or 1941, I believe. That second form of regulation, over which we have no control, was removed approximately a year ago I believe. So we have had two different changes occurring simultaneously. One, the elimination of the antitrust decree. The other is a shift on the rate of return element of the methodology on the Interstate Commerce Commission. I do not think I can give you an estimate on what the combined effect of those two changes will be.

Mr. **Anderson.** In your opinion, do you believe rates would increase or decrease in the same manner and to the same extent if H.R. 2677 were enacted into law?

Dr. **Means.** That question raises again the question of monopoly power. I believe in most markets rates would not increase. I would have to leave open the possibility, particularly pending the completion of the Antitrust Division study, that in the absence of regulation of overall rate levels, there may be markets in which oil pipelines possess sufficient monopoly power, that rates would go up in the absence of regulation. I would have to treat that as an open question until the study is completed.

Mr. **Anderson.** I have further questions but I think I will hold them until after we go around.

Mr. Daub?

Mr. **Daub.** Do you believe that the OMB view is correct that a monopoly pipeline is better than no pipeline at all?

Dr. **Means.** Yes. That given the efficiency of the oil pipelines in moving oil, if that is the choices before the committee, I think that the answer is easy.

Mr. **Daub.** If it is possible to isolate markets or pockets in which a pipeline has monopoly power, is it possible to maintain regulation in that market without creating chaos?

Dr. **Means.** There are substantial practical difficulties involved in doing that. For example, one might find that there was monopoly power on one segment of a pipeline and not on another.

I was personally involved, the Commission was involved in the very preliminary steps towards dealing with those difficulties about 1 year ago. We have not been—I have not been involved, the Commission has not been involved in trying to work out those technical problems over the last year. I am not familiar with the progress that has been made in dealing with those.

Mr. **Daub.** You state that while there may be pockets of monopoly power where complete deregulation may not be appropriate, you doubt that traditional and permanent Federal rate regulations would be justified.

How extensive would these pockets have to be to justify Federal rate regulation? How do you weigh where we should or should not have Federal rate regulation?

Dr. **Means.** The Commission itself, in the Williams decision, laying down a nontraditional methodology—in some respects traditional for the ICC, but not traditional public utility regulation—left open the possibility that that approach might not be appropriate for TAPS.

Now, in the case of TAPS, we are dealing with a pipeline that accounts for about one-half the total revenues of the industry. That is very large, and the Commission itself left open that possibility.

Mr. **Daub**. What type of limited pricing regulation would you consider in other cases not justifying full Federal rate regulation in a traditional sense?

Dr. **Means**. Could you restate the question, please?

Mr. **Daub**. Can you justify any kind of limited price regulation? Is there a place where it fits then as far as you are concerned?

Dr. **Means**. I am not sure whether you are talking about a place in the geographical sense; that is, are there pipelines, let us leave TAPS to one side?

Mr. **Daub**. Yes, please.

Dr. **Means**. About all I can say is I can imagine, based on what we now know on the basis of the studies completed to this date, finding that there are some major pipeline corridors where the monopoly power is large enough to justify a continuing limit on the overall rates being charged.

Mr. **Daub**. Would you hazard at this point to sort of generally tell me where you think those geographical areas are?

Dr. **Means**. I do not—my understanding is that the study will be completed quite soon. I do not think that it is going to help to have my guess on this.

Mr. **Daub**. Comment on this view. If no price regulation is warranted, total deregulation logically should follow.

Dr. **Means**. That I think comes fairly close to being a position that I have taken in my statement, that the monopoly power that allows excessive overall rates is essentially the same monopoly power that allows discriminatory rates.

Mr. **Daub**. I think that is all I need to ask at this time.

Mr. **Anderson**. Thank you, Mr. Daub.

Mr. Breaux, I have placed your opening statement in the record. The floor is yours.

Mr. **Breaux**. I thank the chairman.

I just want to thank the Chairman for having the hearings. It is something that I have been interested in for a long time, along with a number of other members. I think that it is really appropriate that the Public Works and Transportation Committee and particularly this subcommittee look at this legislation at this time. If you look at the history of this committee with regard to deregulation and decontrol in trying to approach a free market, and for most means of transportation, I think that everybody would have to agree that the record is very good with regard to what this committee has done with regard to airline deregulation, and also the trucking industry. I think these are some real milestones that this committee has embarked upon and has enacted into law. I think it is really hard to argue ultimately that the Government should not be the authority that determines what rates are and how people enter into a market or get out of a market that the free enterprise system can best determine those particular solutions.

This legislation is certainly in keeping with that tradition of allowing the free market to determine how something is going to be transported. I think it is particularly unique in this area that when you are looking at oil pipelines, as far as regulation is concerned, that this legislation is appropriate.

The other chief means of transporting oil in this country is, of course, basically deregulated. Water transportation, which accounts for more than pipelines, does not have to go to FERC, does not have to go to the Department of Energy, does not have to go to Congress to determine what they are going to charge to transport oil in this country. The marketplace determines that. Yet the other large segment of transportation, of course, is encumbered by a rather antiquated system which was started back in 1906, as I remember. So I think the legislation is appropriate and I would thank the chairman for allowing this committee to move forward with the hearing process.

Dr. Means, thank you for your statement. It is very detailed and, of course, a great deal of work has gone into it.

Let me ask the question—I think what you are saying is that it really depends on whether decontrol and deregulation is in the public interest, is determined based upon the potential for monopolies being formed in that particular industry. And you say that is the real question that we have to ask here.

Can you ever figure that out unless you try it? We have 138 companies that are transporting crude oil that have to go before FERC, and I guess the average person on the street would say, well, that sounds like an awful lot of companies. Can we not make a cut right now and say give it a try and if, in fact, monopolistic practices form, well, then, we could come in with some sort of reregulation if that would prove to be necessary.

Can we find out if it is going to happen unless we try?

Dr. MEANS. I think you are perfectly right. We are not, on the basis of studies of industry structure, going to be certain as to what would happen under deregulation. Perhaps I could qualify that in two respects.

One is we are probably not going to know for sure, even after we try, because we are never going to know what the world would have been like had we gone down the other path.

The second would depend, I think, on the meaning of trying and reregulation. Whether what would be contemplated would be a period of potentially some years followed by new legislation in the event that the results were unsatisfactory, or whether what would be contemplated would be a briefer period with the potential for automatic reimposition of regulation in some markets, if results were unsatisfactory on the basis of a briefer trial.

Mr. BREAUX. Can we draw an analogy to what has occurred with regard to oil prices, since the pricing of oil has been decontrolled now for about what, 2 years?

Dr. MEANS. Yes.

Mr. BREAUX. Is there an analogy that can be drawn? You know, they were talking about the sky falling in if we ever decontrolled the price of oil, and we have done that and we have had it on the books now, I guess, for 2 years or so, and the sky is not falling and prices have not changed really very much at all.

Is there any analogy that can be drawn from that decontrol with regard to oil pipeline transportation pricing?

Dr. MEANS. There is an important analogy because what it points out is that the market in crude oil and oil products is a competitive one. And we discovered that competition was actually determining the average price even under the oil price control, so that the oil price controls had no immediate effect on price.

That same competition in the crude oil markets and in refined products places an important limit on not just those markets but also on the price that could be charged for transporting the oil because, as I said earlier, a refinery on the seacoast can simply turn to imported oil if it is unhappy with the rate that it is having to pay for oil brought up from Texas or Louisiana. It is certainly true that complete deregulation of the oil pipeline industry would not cause the sky to fall. For one thing, the amounts that are at stake are far smaller than the amounts that were at stake on the price being paid for the crude oil. The question I have been trying to address is, is it possible that there are markets in which either sellers of oil will receive less or buyers of oil would pay more because of an increase in transportation charges under deregulation? And the only honest answer I can give to that at this point, is based on what we now know, there may well be some such markets.

Now, if on balance it is determined that the explicit and implicit costs of regulation are greater than that danger, I think I can also say, as you suggest, the sky is not going to fall if the Congress goes down that path.

Mr. BREAUX. It is allowable and not only allowable, probably appropriate, that different companies would charge different rates, but as long as they charge the same rates to all other individual customers, right?

Dr. MEANS. Yes.

Mr. BREAUX. So you would have different prices being charged, more efficient lines might be able to charge less to ship oil than a less efficient line?

Dr. MEANS. Yes.

Mr. BREAUX. So you would have price differences even under deregulation?

Dr. MEANS. Yes.

Mr. BREAUX. The final point I want to make, it sounds to me, at least my first impression, is that something that is inequitable in an economy such as ours that regulates half of the transportation costs for shipping any product, in this case crude oil, and does not regulate the other half of the transportation means, and what I am talking about is how could it be justified economically to say that we are not going to regulate or control in any way how much you are charged to ship oil by water transportation, and yet if you put the same product in a pipe and send it to the same destination, however that justifies the Federal Government being involved in it. Is it from an economic standpoint? Does that make sense?

Dr. MEANS. Let me first compare this situation with the one that was faced by the railroads, before there was a substantial measure of deregulation.

The railroads faced a similar situation in competing with barge lines, and there, the railroads had a serious problem, because the Interstate Commerce Commission was holding up railroad rates, really not making possible, in some circumstances, for them to compete effectively with the barge lines.

To the best of my knowledge, that has not been a complaint or a concern of the oil pipelines, in competing with the barge lines. There will be, I am sure, witnesses who will correct me if I am wrong on this, but to the best of my knowledge, the oil pipelines have not been handicapped in competing with the barge lines in that way.

Mr. BREAUX. I am not so much looking at the practical effects, which, of course, should be our primary concern, but philosophically. Can we justify saying that if you ship it by water it is going to be deregulated, and no controls, and yet if you put it in a pipe we are going to regulate it. Economically, is there any justification?

Dr. MEANS. Well, let me answer in two steps.

For a proponent of regulation, the answer would be that barges are competitive because it is very easy to shift barges, I would say my knowledge of barge lines is rather limited, but at least as I picture barge lines, it is very easy to move barges from one river route to another, whereas oil pipelines have economies of scale, and once it is one place, it cannot be some place else. So oil pipelines start out looking like a typical natural monopoly, whereas barge lines do not.

That first answer, I think, is an oversimplification, because oil pipelines do compete with one another, and because they do face competition in one way or another from refineries located immediately at the markets, and so what is in a technological sense, just because of the way pipes work, natural gas pipe, or oil pipes, a natural monopoly in fact has substantially less market power than one would suppose if it were a world in which the only thing that existed were oil pipelines.

So the answer to your question is, there are significant differences between barge lines and oil pipelines, that may be used to justify regulating one, and not the other. But the differences are less than appear from looking simply at the technology of oil pipelines.

I am sorry that is a long answer, but that is——

Mr. BREAUX. Thank you for your testimony. I think it has been helpful.

Mr. ANDERSON. Dr. Means, under the consent decree that limited the dividends of vertically integrated oil pipeline companies to their owners, 7 percent of evaluations of such pipelines carries property, the evaluation is either determined by the Interstate Commerce Commission, or if the Commission had not yet done evaluation, the evaluation is based on the carrier's own records.

What effect did this have on the financial structure of the oil pipeline industry?

Dr. MEANS. It had an effect on the financial structure. The dividend limitation was not a limitation on return on equity, but return on total rate base, and the decree placed no limitation on return in the form of interest on debt.

It therefore created a very strong incentive to finance through debt. So that 7 percent of the entire valuation was focused on a very small slice of equity. And as a consequence, debt equity ratios of 9 to 1, 10 percent equity, 90 percent debt are not at all uncommon in the oil pipeline industry.

Mr. **Anderson**. What effect did the consent decree have on pipeline rates?

Dr. **Means**. I do not think anybody can answer that, because as one looks at the rates charged in the past, one knows what they were, one knows that they were in conformity with the relevant legal rules.

What one does not know is to what extent the rates were really being determined by competitive forces, rather than by the legal rules.

Mr. **Anderson**. What effect, if any, has the removal of the consent decree limitation had on rates and the financial structure of the industry?

Dr. **Means**. I cannot—I cannot answer. I am not aware of any before and after studies on that, Mr. Chairman.

Mr. **Anderson**. Mr. Shuster?

Mr. **Shuster**. Thank you very much, Mr. Chairman.

Dr. Means, thank you for your testimony. I have one question.

Since we passed motor carrier regulatory reforms which provided for significant deregulation, particularly among other areas in the area of pricing, we have had numerous complaints of price discrimination.

Now, to what extent do you believe there is price discrimination today in oil pipelines, and to what extend do you think there might be, should we proceed?

Dr. **Means**. With respect to the first question, my impression is that the Commission has received very few complaints of price discrimination.

With your permission, I would like to confirm that with Mr. Bullock of our office.

[Pause.]

I would like to confirm that, but our understanding is that we the Commission has received—outside of the TAPS and Williams' case—no complaints of price discrimination.

I would like to confirm that, however, from the records.

Ms. Church informed me that she thinks that there perhaps are three. With your permission, I would like to submit that for the record, after having a chance to check the records:

[The question posed and the response received from Dr. Means follow:]

How many oil pipeline cases are pending at the FERC? Seven cases are currently pending at the FERC. They are:

Cook Inlet Pipe Line Co., Docket Nos. IS83-40 *et al.*
Gulf Central Pipeline Co., Docket Nos. IS83-26.
Kuparuk Pipeline Co., Docket Nos. IS82-54 *et al.*
Phillips Pipe Line Co., Docket Nos. IS78-1 *et al.*
TransAlaska Pipeline System, Docket Nos. OR78-1 *et al.*
Williams Pipe Line Co., Docket No. OR79-1 *et al.*
Wyco Pipe Line Co., Docket No. IS83-34.

Ms. **Church**. If I could just clarify that.

I did check with our enforcement staff, and there have been a few complaints over the years on discrimination in services of prices, and the enforcement staff right now has three investigations going, two of which are nonpublic, into primarily discrimination in services between affiliated, nonaffiliated shippers, but on a whole, and those involve crude pipelines, rather than product pipelines, but on the whole, there has not been a large number of complaints that the Commission has received.

Mr. SHUSTER. If we were to pass H.R. 2677, what is your estimate of what the impact would be, as far as price discrimination is concerned?

Dr. MEANS. One way in which it would have a potential impact would be if there are markets in which in the absence of just and reasonable rates would allow vertically integrated oil pipelines to raise their rates uniformly to all shippers.

We might then find independent shippers claiming that this was discriminatory, since it constituted a real economic cost for an independent shipper, while it did not, in the same sense, constitute a real economic cost for the corporate affiliate of the pipeline.

That would then raise the legal question whether the Commission's continued authority over discriminatory rates extended to the case of rates that were uniform, but could be argued to have a differential impact on independent and affiliated shippers.

Discrimination in the way that I think you would ordinarily think of it, charging one rate to A, and one rate to B, on the face of it, it should not be any different as a consequence of H.R. 2677 than it is today.

[The question posed and response received from Dr. Means follows:]

How many complaints has the FERC received based on price discrimination?

Since the FERC obtained jurisdiction over oil pipelines in 1977, it has received six complaints in which the price discrimination issue has been raised. The cases arising out of those complaints are:

Dome Pipeline Corp., Docket Nos. IS81-60 et al.

Enterprise Products Co. vs. Santa Fe Co., Docket Nos. OR81-5.

Hydrocarbon Trading and Transport Co. vs. Texas Eastern Transmission, Docket No. OR84-2.

Kerr McGree Refining Corp. and Oklahoma Refining Co. vs. Sun Pipe Line Co., Docket No. OR82-30.

Mid-America Pipeline System, Docket Nos. IS83-25 and IS83-30.

Wyco Pipe Line, Docket No. IS83-34.

Mr. ANDERSON. Mr. Smith?

Mr. SMITH. Thank you, Mr. Chairman.

Is it possible for a company to have a monopolistic position in a portion or segment of a pipeline?

Dr. MEANS. Yes.

Mr. SMITH. It is possible?

Dr. MEANS. We are talking about—this is not—yes, he short answer is yes.

Mr. SMITH. What is the difference between—economically, between a pipeline, water carriage, and let us say other transportation, trucking, percentagewise, roughly?

Dr. MEANS. I read through the NERA study over the weekend. I am sorry I do not have the percentage. I can provide that for you. It is necessary to be careful about what kind of products one is talking about being shipped, at least the NERA study notes that there are some kinds of products that simply do not lend themselves to going through a pipeline, and as a consequence those are not carried by pipeline.

I would prefer to give that answer for the record. I do not have the percentage.

[The question posed and response received from Dr. Means follows:]

What are the market shares of the various oil transportation modes?

The following table provides information on oil transportation market shares. The source of this information is the Association of Oil Pipelines, "Pipelines Continue to Lead All Other Forms of Transport in Tonnage Movement of Oil in 1980 but Water Carriers Lead in Ton-Miles," press release, July 29, 1982, Table 1, and is reproduced in the NERA study, "Competition in Oil Pipeline Markets: A Structural Analysis," page 60.

OIL SHIPMENT SHARES BY TYPE OF CARRIER—1980

Type of carrier	Tons		Ton-miles	
	Shipments (million)	Share of total (percent)	Shipments (billion)	Share of total (percent)
Pipeline	920	46	576	47
Water	509	26	618	50
Motor	539	27	27	2
Railroad	23	1	12	1
Total	1,991	100	1,233	100

Mr. SMITH. I am trying to get at the question, and the universe of the question simply is, what advantage does a pipeline have in a monopolistic position over any other transportation, and if there was total deregulation, the roof, in the worst case, would fall in, to the extent of that advantage?

Dr. MEANS. The four potential competing modes are trucks, trains, barges and oceangoing tankers. Trucks are effective competitors, up to a relatively short distance.

The practical significance of that is that if there is a refinery in the immediate area of a producer, he has a perfectly effective alternative in simply taking his oil to that refinery by truck, but they cease to be effective competitors over any appreciable distance.

Mr. SMITH. Will your study show the length of a line that may be held in a monopoly manner so as to check that advantage, let us say, over the worst case, probably would be trucks?

Dr. MEANS. There are, I believe, I think there is some consensus as to the distance. Fifty to one hundred miles, I believe, but I can consult with one of my staff, if you like, I can consult with him now.

Mr. SMITH. That is fine.

Dr. MEANS. For the longer distance the effective competitors are either barge lines or oceangoing tankers. I think that we have gained in sophistication as the successive studies have been submitted. Based on the most recent study now available, which is the NERA study, it would appear that barge lines would limit oil pipeline rates, but are probably a fairly high limit, whereas oceangoing tankers probably are a very effective limit on oil pipeline rates, for example, for a refinery that could either buy crude oil brought by the oil pipeline up from the producing areas, or buy imported crude, brought in by tanker. That is probably a very effective limit.

Mr. SMITH. So I am assuming that your study will identify the lines, the length of the lines, the monopolistic position that is held by a company, and the alternatives to that in the transportation differential?

Dr. MEANS. The study that is forthcoming is by the Antitrust Division of the Department of Justice. I think Mr. Baxter may speak about that in his testimony later this morning.

My understanding is that it will be out soon.

Mr. SMITH. Is that study forthcoming?

Dr. MEANS. Soon is the word that was used in speaking to me. I will leave it to Mr. Baxter.

Mr. SMITH. So is Christmas to my children.

Dr. MEANS. Yes.

Mr. SMITH. Thank you.

Mr. ANDERSON. Mr. Daub, did you have anything further, before I get back to my questions?

Mr. DAUB. No.

Mr. ANDERSON. Dr. Means, I would like to clarify one point.

If pipelines not having monopoly power were deregulated, would those deregulated pipelines be subject to the provision of the Elkins' Act?

Dr. MEANS. My understanding is that under H.R. 2677, they would be subject to the provisions of the Elkins' Act, That is my——

Mr. ANDERSON. If they were totally deregulated?

Dr. MEANS. You mean if we were to eliminate all—I am sorry, not under H.R. 2677, but complete deregulation. I would think that if there were complete deregulation, that is, if you were to eliminate the antidiscrimination provisions, then the logic of that would dictate removal of limitations under the Elkins' Act. That would be—we are referring to the antirebate provisions of the Elkins' Act?

Mr. ANDERSON. Yes. My follow up is, if the answer was no, then what legal restraints, if any, would govern dividend payments from a pipeline to an affiliate or parent company?

Dr. MEANS. If the Elkins' Act were removed, and the antidiscrimination provisions were removed, then there would appear to be no limitations on the dividends that they could pay, except the dividends have to be paid out of profits, the ultimate limitation on dividends would not be directly on dividends, but on the profits that they could earn in what was assumed to be a competitive market.

Mr. ANDERSON. In his written testimony, Mr. Baxter from the Justice Department, describes the regulatory apparatus as a costly one.

How much would you say the Federal Government expends annually on regulating the oil pipeline industry?

Dr. MEANS. I am sorry, we do not have that number at hand.

Mr. ANDERSON. Would you want to get that for the record?

Dr. MEANS. I would be happy to, sir.

Mr. ANDERSON. And would you make an estimate on how much this regulation either costs or saves the American public?

Dr. **Means**. I might say that the cost to regulation probably does not consist primarily in the, the bureaucratic salaries that are involved; if the regulation has costs, and it does have costs, they are much more likely to take the form of distortions of decisions and capital structures. Those kinds of costs are likely to be much higher than the direct rates or costs, but the regulatory costs we will provide for you.

Mr. **Anderson**. And also, how much it costs or saves the American public.

Dr. **Means**. We will do the best estimate.

[The questions posed and responses received from Dr. Means follows:]

How much does the regulation of oil pipelines cost?

How much does it cost or save the public?

The costs of oil pipeline regulations can be subdivided into a number of categories, some of which can be quantified and some of which cannot. The most obvious cost is the amount of resources at the FERC devoted to oil pipeline regulation. In fiscal year 1983, about $6.2 million was appropriated in the FERC budget for oil pipeline regulation. The various private parties affected by oil pipeline regulation, e.g., the oil pipeline and their customers, also incur costs such as legal expenses to participate in litigative proceedings and other regulatory activities. In principle those costs could be calculated, but the data required to do so are not available. Finally, oil pipeline regulation may lead to economic inefficiency. For example, since regulation at least in theory places a cap on the rate of return allowed to the pipeline owners but generally allows cost increases to be passed through in rates, pipelines may have less incentive to keep their costs as low as possible. Some costs of this kind are almost an inevitable byproduct of regulation, but in practice it is vitually impossible to make a realistic estimate of their magnitude.

The benefits of oil pipeline regulation are linked to the prevention of what monopolistic abuses that would otherwise take place in the industry. For example, to the extent that pipeline transportation rates would be higher without regulation than otherwise, prices received by oil suppliers would be lower and/or the prices paid by oil consumers would be higher than otherwise. Lower prices received by oil suppliers migh discourage some domestic oil from being produced, which might be replaced by oil from more expensive and unreliable foreign sources. Higher oil prices faced by consumers might cause some consumers to turn to more expensive alternate fuels or cause some industrial users to reduce their level of production, resulting in increased unemployment. To the extent that regulation reduced these problems, society would benefit. However, the value of these benefits has not been quantified.

Mr. **Anderson**. Later today, Robert Maynard, the Assistant Attorney General for the State of Alaska will testify that:

> The ability of TAPS' owners to use TAPS to shelter oil income from the windfall profits tax and States' severance tax on royalty obligations has been the subject of several Congressional-IRS State hearings. Deregulating TAPS would give near total discretion to the owners to shift revenues away from their tax liable producing affiliates to their pipeline subsidiaries.

Now, do you agree or disagree with that statement, and please explain why you agree or disagree with that statement?

Dr. **Means**. Let me try to answer, to a limited degree, as I indicated earlier, because TAPS is under litigation, but let me try to say what I can say in response to that.

Roughly a year ago, when there were hearings, my understanding of the position of the Department of the Treasury was that they did not have concerns with respect to the windfall profit tax under the bill as then being submitted.

My recollection, however, was that the bill then being submitted was one that did not deregulate TAPS. There are safeguards in the windfall profit tax for this kind of distortion of prices to avoid tax.

I simply do not know, one way or another, whether they are effective for TAPS, as the Department of the Treasury does assume they are effective apparently for the lower 48 States.

With respect to the State royalty taxes and the States' interests, without hearing the merits of it, that is precisely what is at stake on the regulation of TAPS. Since the price of crude oil is determined competitively, ultimately by the time it gets to the lower 48 States, what is at stake in the TAPS case is, is there monopoly power? If there is, the affected party would be primarily the State of Alaska.

Now, that identifies the issue. The merits of the issue are in virtually every respect tied up in litigation of the TAPS case, and I cannot comment on that.

Mr. **Anderson**. To what extent do the oil producing and/or the refining companies own or control pipeline transportation companies in the contiguous 48 States?

Dr. **Means**. The industry is overwhelming vertically integrated. Williams is one major independent oil pipeline, but for the most part, the industry is vertically integrated. The major oil companies do control most of the pipelines.

Mr. **Anderson**. Mr. Breaux?

Mr. **Breaux**. Just one.

Dr. Means, I guess when we moved this legislation forward, that for those who would not have had the opportunity to sit and listen to all the witnesses, and all the discussion in the committee, when the bill comes to the floor, an awful lot of members are going to say, well, we are not going to be for that, because you are removing the protection that consumers have against unduly high prices for transporting crude oil, and we are not going to be anticonsumer.

I notice in FERC's news release, back in November of 1982, with regard to the decision on the Williams' case, that it was stated in the release that the consumers' stake in the outcome of oil pipeline ratemaking is so negligible that the Commission has little reason to stretch the statute into a consumer protection measure.

Can you elaborate on that? Apparently what they are saying, what FERC is saying in this case, is that if you think that the present structure is a consumer protection act, you are wrong. It is really not that at all, and it should not be interpreted to do that.

Can you comment on that?

Dr. **Means**. Yes. To the extent that the refined products that are consumed by American consumers are refined in coastal refineries, then what is at stake is not, I think, to any significant extent the price paid by consumers, because as I mentioned earlier, those refineries have the alternative of obtaining their crude oil by oceangoing tanker, and that price of oil from oceangoing tanker effectively determines the price that they are going to pay for crude oil.

Therefore, even if one were to hypothesize that there is significant monopoly power on some of the oil pipelines bringing oil to those refineries, the affected parties would not be the consumers of the products produced by those refineries, but the producers who sell crude oil to the refineries.

Mr. **Breaux**. Well, suppose they come back and say sure, but they are just going to have their price that they sell the refined product to the consumer reflected in the price of transportation?

Dr. **Means**. Well, if a refinery is able to obtain a certain grade of crude oil, delivered to the refinery, by oceangoing tanker at $29 a barrel, then it simply is not going to pay more for oil delivered from Louisiana or Texas, than $29 a barrel.

To the extent that the transportation cost is higher, the result is not going to be that the refiner pays a higher price, but simply that the procurer receives a lower price. And that competition from tankers, in carrying oil to the refineries, greatly diminishes the potential impact on consumers, no matter what you assume about the monopoly power of the pipelines.

Mr. **Breaux**. Thank you.

Thank you, Mr. Chairman.

Mr. **Anderson**. Thank you, Mr. Breaux.

Well, thank you, Dr. Means, and Ms. Church, for your presentation.

Our next witness is Mr. William Baxter, Assistant Attorney General, Antitrust Division, Department of Justice.

Mr. Baxter, the full text of your prepared statement will appear in the record at this point.

[Statement referred to follows:]

Department of Justice

TESTIMONY

OF

WILLIAM F. BAXTER
ASSISTANT ATTORNEY GENERAL
ANTITRUST DIVISION

BEFORE THE

SUBCOMMITTEE ON SURFACE TRANSPORTATION
COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION
HOUSE OF REPRESENTATIVES

ON

H.R. 2677

OIL PIPELINE REGULATORY REFORM ACT OF 1983

NOVEMBER 9, 1983

Mr. Chairman and Members of the Subcommittee:

I welcome the opportunity to appear before the Subcommittee on Surface Transportation of the House Committee on Public Works and Transportation to present the views of the Department of Justice on deregulation of the oil pipeline industry. While this is my first appearance before this Subcommittee on this topic, this marks the fourth time in the past two years that I have testified before Congress on oil pipeline deregulation.

In my earlier appearances, I told Congress that the Department was committed to exploring all possible opportunities to reduce the burdens of federal regulation on interstate petroleum pipelines. At the same time, I noted that the Department was concerned about the bills then before the Congress that would remove rate regulation for all pipelines without regard to the presence or absence of market power in particular lines. I explained in detail why it did not appear that a case-by-case approach to deregulation was likely to be fruitful, and promised a diligent effort to devise alternative legislation based upon an ongoing, in-depth study of the petroleum pipeline industry. I am pleased to report to you today that we are now very far down the road toward that desired goal.

Before describing that study and its implications in some detail, I want to make clear at the outset that I still have the same reservations I expressed last year about various bills--such as H.R. 2677--that do not distinguish among pipelines in calling for deregulation. H.R. 2677 would deregulate the rates of all interstate oil pipelines subject to regulation by the Federal Energy Regulatory Commission ("FERC"). Its main virtue is that it would accomplish this with dispatch. However, the bill, like its predecessors, has several flaws. First and foremost, the bill does not discriminate among pipelines, but deregulates those possessing significant market power as well as those which do not. The Department continues to believe that a sorting mechanism should be expressly included in any deregulation statute--one that will result in general and complete deregulation of a large proportion of the oil pipeline industry.

Second, H.R. 2677 repeats the error of its predecessors in deregulating rates while leaving intact the common carrier and antidiscrimination provisions contained in the Interstate Commerce Act. The bill envisions a deregulated world in which every pipeline is free to charge whatever rates it wishes, but is required to publish tariffs and provide nondiscriminatory access to the facility. The Department believes that if rate deregulation is justified due to competitive factors, then access regulation and published tariffs are superfluous at best. Conversely, if denial of access to the pipeline is a legitimate fear, it must be because the pipeline lacks sufficient competition to justify deregulating its rates. A pipeline with no market power does not need costly rate regulation; nor does it need the equally costly regulatory apparatus designed to ensure equal access to all shippers. If a pipeline does have market power, access regulation alone will be of very limited utility, given the ability to charge a supra-competitive rate. Thus, unless access regulation is used to subvert rate deregulation, access for a shipper with no ownership stake in the pipeline may be meaningless.

Finally, aside from regulatory costs, access regulation may itself be inherently anticompetitive. For example, the requirement of published tariffs from which no deviation is permitted may inhibit competition or facilitate collusion among competitors. LOOP, the deepwater port off the Louisiana Gulf Coast, has argued persuasively before Congress that tariff filing requirements have inhibited LOOP's ability to compete with alternative modes of shipment by lengthening its response time in the marketplace.

Another serious flaw in H.R. 2677 is its failure to exclude the Trans-Alaska Pipeline System ("TAPS") from its deregulation provisions. TAPS has been the subject of a complex regulatory proceeding for a number of years regarding the appropriate methodology for regulating its rates--a proceeding in which the Department has been deeply involved from the outset. For the reasons articulated by the Department in that proceeding, deregulation of TAPS would be a serious mistake. TAPS has substantial market power and therefore the ability to affect wellhead prices of crude oil on the Alaska North Slope. This, in turn, could affect exploration and production in the North Slope area, as well as state and federal revenues from taxes, leases, and royalties in that area. Downstream, an unregulated TAPS could seriously affect crude oil and product prices on the West Coast.

Before turning to a description of our proposed alternative to H.R. 2677, let me first describe for you the empirical work that has been underway in the Antitrust Division since last year, and upon which our legislative recommendation will be based. Our belief that some pipelines possess market power and some do not is in the process of being tested against the available evidence, by examining each oil pipeline market in the lower-48 United States and assessing the degree of competition in that particular market. Our study will mark the first systematic effort of which I am aware to assess competition in every interstate pipeline market in the nation.

We began our study by applying fundamental economic principles to pipeline markets, in order to develop criteria and a sound methodology for assessing market power. Concentration levels are important in assessing market power, and, using the same methodology used in the Department's Merger Guidelines, we decided to calculate Herfindahl-Hirschman index ("HHI") concentration levels in each market. In making HHI concentration calculations, we are accounting for competition faced by pipelines in a number of different ways. For example, refineries compete with a product pipeline in markets where product can be taken off the pipeline ("destination markets"), and with a crude pipeline at the pipeline's points of origin ("origin markets"). In crude pipeline destination markets, there is competition from local crude production. In product pipeline origin markets, there is competition from local consumption of products. In all these markets, other pipelines and other modes of transportation also must be taken into account in assessing pipeline competition.

While data availability has made necessary the use of political boundaries to define the geographic extent of origin and destination markets, we believe those markets correspond closely to real economic markets. The preliminary geographic markets we used are the 181 Economic Areas into which the Bureau of Economic Analysis of the Department of Commerce has divided the United States. Called BEAs for short, these geographic areas represent pragmatically defined areas of economic activity around a traditional hub or major city. We have been able to obtain a great deal of useful data organized on a BEA basis. Equally important, BEAs are a reasonable initial approximation of geographic pipeline markets because they represent approximately the maximum area that can economically be served by the highly competitive trucking sector.

In certain important respects, our study goes beyond identifying and quantifying concentration-oriented competitive factors in the oil pipeline industry. Even in markets where there is a high level of concentration, and hence an apparent lack of competition, apparent market power sometimes is not real. We also are considering whether rate regulation is inherently incapable of addressing certain market power problems that may exist in some markets.

Let me conclude my discussion of our pipeline study with two important caveats. First, the data that we are relying on in calculating HHI concentration indices are in some cases not current, and in other cases only approximations of possibly better data that may be privately held but are publicly unavailable. We hope that those interested in pipeline deregulation will inform the debate by providing us with detailed and corrected data wherever that may be appropriate. Second, the study's focus at this juncture is on pipeline markets, not the pipelines themselves. Although an appraisal of whether particular pipelines are likely to be good candidates for deregulation can be made by applying the methodology described in the study to such pipelines, we have not completed this task. We will not regard the study as complete until this job has been done.

I think the best way for me to explain our methodology is to discuss a few hypothetical examples. The examples largely will describe hypothetical pipelines that serve only one destination market. In reality, however, almost all the major interstate oil pipelines serve multiple origin and destination markets, thereby substantially complicating the analysis when one is required to balance concerns about high risk markets against the benefits of deregulation in non-high risk markets served by the same pipeline.

The examples will concern product pipelines supplying a market "A". The examples assume that the nearest refineries and port facilities are well over 100 miles away from the major cities of market A and thus can be excluded from the analysis. For ease of illustration, assume that the pipelines do not raise a need for regulation at their origins.

Example 1

Suppose three product pipelines, X, Y, and Z, supply market A. Suppose that the throughput capacities of X, Y and Z are 100 thousand barrels per day ("MBD"), 50 MBD and 50 MBD, respectively. Suppose the pipelines are operating near full capacity, and that market A is the sole destination of the pipelines. The market shares of X, Y, and Z are 50%, 25% and 25%, respectively, yielding an HHI equal to 3750. The Department believes that such a market is "high risk", in terms of the dangers of noncompetitive performance, and on the basis of such concentration would recommend that X, Y, and Z each continue to be regulated.

Example 2

Suppose there are five product pipelines supplying market A, each with capacity of 50 MBD. Suppose the pipelines are operating near full capacity and that market A is the sole destination of the pipelines. The market share of each pipeline equals 20%, yielding an HHI equal to 2000. The Department would recommend deregulating each of these five pipelines, although one might note that an HHI of 2000 is well above the area of concern in our Merger Guidelines. However, we view the imposition of regulation as a considerably more severe consequence than the denial of an opportunity to merge freely without regard to competitive consequences, hence the higher threshold of concern.

Example 3

Suppose product pipelines X, Y, and Z supply market A and have throughput capacities of 100 MBD, 90 MBD and 10 MBD, respectively. Suppose the pipelines operate near full capacity and that market A is their sole destination. The market shares of X, Y, and Z are 50%, 45% and 5%, respectively, yielding an HHI equal to 4550. In this case, concentration ratios indicate that X and Y should continue to be regulated, but the case for regulation of Z is questionable, due to its small market share. If X and Y continue to be regulated, deregulation of Z is not likely to have significant adverse effects on economic welfare.

Example 4

Suppose that market A is supplied by a pipeline X and four other pipelines, and that the total delivery capacity in the market is 500 MBD, with pipeline X having 300 MBD and the others 50 MBD each. Suppose further that X passes through A to supply additional markets, and that the other four pipelines, which operate at capacity, have A as their sole destination. Suppose total consumption in market A is 250 MBD. Since the four other pipelines each are operating at 50 MBD, the indicated delivered throughput of X to A is also 50 MBD. Each pipeline then has a delivered throughput share in market A of 20%, yielding a delivered throughput HHI of 2000. The four smaller pipelines can be deregulated since A is their only destination market. Market A should be considered "non-high-risk" for pipeline X; whether X will be deregulated depends upon the competitive structure of the other markets which it serves.

Example 5

Suppose the sole supply for market A is a product pipeline X which is vertically integrated with its supplying refinery X. Suppose also that refinery X is a monopolist in the market where pipeline X originates at refinery X. As a monopolist in market A, pipeline X has an HHI of 10000. But should it be regulated? Notwithstanding the evident market power of pipeline X, the owner of the pipeline and the refinery can evade the effort to curb its market power with regulation by charging a monopoly price for the output of refinery X. Hence, to the extent that regulation of pipeline X does not restrain the ability of its owner to extract monopoly profits in market A, the Department would see no utility in regulating pipeline X.

I hope the Subcommittee can appreciate from these few examples just how complicated is the task of sorting out those few situations in which regulation of pipelines will curb the exercise of market power from the many in which regulation is either unnecessary or ineffective. The examples I have given are of course quite simplified; they do not address other factors, such as not-so-distant refineries or port facilities, that could lead to the conclusion that a particular pipeline should be deregulated notwithstanding a high HHI index. The Department is still engaged in this exercise, translating the data into conclusions about specific pipeline systems. While I cannot yet provide specifics, I feel confident in stating that the expectations we have expressed over the last several years appear to have been confirmed: a significant portion of the pipeline industry is comprised of good candidates for deregulation. While some pipelines will require more study than others, it is likely that at least two-thirds of all pipeline companies, representing approximately one-half of all barrel-mile throughput, should be deregulated.

The Department believes that these pipelines should be deregulated quickly, through some appropriate expedited process, such as a rulemaking. The Department, in addition to completing its pipeline-by-pipeline study, is working with other interested agencies to devise a proposal for legislation that would establish such a process and set forth appropriate criteria that will identify pipelines whose deregulation is clearly warranted. The legislation should also deal with less obvious situations that upon closer study would present equally valid cases for deregulation, as well as with those pipelines, in addition to TAPS, requiring continued regulation.

While a number of details remain to be worked out, we see this legislation as having the following features:

- The Department of Justice study should serve largely as the basis for an initial determination of which pipelines obviously should be promptly deregulated.
- Each pipeline not deregulated initially would be eligible for deregulation through an administrative determination.
- A pipeline should continue to be regulated only if it has substantial market power, if regulation will effectively constrain the exercise of that power, and if regulation will not substantially reduce the efficiency of the markets served by the pipeline.
- An evaluation of pipeline market power should begin with an assessment of the concentration levels in the origin and destination markets served by the pipeline. As appropriate, these assessments must account for competition from refineries and local production and consumption, as well as from other forms of transportation.
- The question of whether a particular pipeline should be regulated or unregulated should be subject to reexamination under the statutory standard, based upon a clear showing of changed circumstances over time. The statute should, however, limit the frequency of such reexamination to, say, once every 10 years.
- Deregulation should include the elimination of common carrier and tariff filing requirements.

-- The Trans-Alaska Pipeline should not be deregulated.

-- The antitrust laws should apply in full to all deregulated pipelines.

To summarize, Mr. Chairman, the Department agrees with the premise of H.R. 2677, but not with the bill's methodology or its end result. The data and our own preliminary analysis suggest that much of the industry can be safely deregulated. While that cannot be achieved as quickly as some would hope, it can nevertheless be done expeditiously, while preserving regulation where it can curb the exercise of substantial market power.

I thank the Committee for this opportunity to present our views on this complex and challenging topic, and will be glad to respond to any questions you may have.

Mr. ANDERSON. Please proceed.

TESTIMONY OF WILLIAM F. BAXTER, ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, DEPARTMENT OF JUSTICE, ACCOMPANIED BY DAVID W. BROWN, ASSISTANT CHIEF, ENERGY SECTION, ANTITRUST DIVISION, DEPARTMENT OF JUSTICE

Mr. BAXTER. Thank you, Mr. Chairman.

I have had Mr. David Brown, the assistant chief of my energy section, come with me today, and if matters arise where I get in trouble, I may turn to him for rescue.

We, the Antitrust Division, Department of Justice, have testified on pipeline deregulation a number of times, and we have repeatedly taken the position that a sensible answer to this question cannot be given on an industry basis. Rather competitive conditions vary greatly from market to market, and one must simply look at the individual markets in order to arrive at sensible answers.

We have committed ourselves to conducting a detailed study about which Dr. Means made several references, and I will be prepared to tell you a little bit more about that study. We think it will be available now in a matter of days, rather than weeks. That is what we mean by soon—before Christmas—well before Christmas.

I would like to make a few general comments about the pending legislation, H.R. 2677. We think it is deficient in several different respects.

First of all, it is deficient in that it approaches the problem categorically as an industry problem and would deregulate across the industry. There is little doubt, I think, that there are at least some contexts. TAPS is the most dramatic, where such deregulation would impose substantial costs on the economy.

In the case of TAPS, the problem would show up in terms of depressing the wellhead price for crude at the North Slope, rather than as a consumer effect. But the point is that there are four different kinds of markets at which one must look.

There are product origin markets and product delivery markets, there are crude origin markets and crude delivery markets. Every pipeline operates in at least two markets, usually in substantially more than two markets, and the adverse effects of market power, if it is present, may be present in only one of those markets, or in more than one.

So in our view, there simply is no substitute for the grubby necessity of getting in there and getting the information on a market-by-market basis.

A second respect in which we find H.R. 2677 seriously deficient is the fact that it would leave intact the so-called common carrier and antidiscrimination provisions of the present regulatory regine.

Insofar as it is appropriate to deregulate pipelines, insofar as there are not present significant problems of market power, it necessarily follows that those provisions also should be repealed. It is important that they be repealed, in two quite different senses, I think.

If an industry is effectively competitive, then the participants in those markets are protected by competition against excessive prices, and that is what justifies getting rid of the rate regulation. But they also have alternative sources to which they can turn, and therefore they are also protected against discrimination. So that it simply is a costly and needless act to keep this particular regulation in place.

Now, of course, if you have made a mistake, and if you have deregulated pipelines that continue to have substantial market power, why then the phenomenon of discrimination may arise as well, but insofar as it is wise to remove one kind of regulation, it is wise to remove the other; indeed, it is unwise not to remove it for the reason I have already indicated, simply because a costly apparatus is needlessly left in place, but for a second and perhaps a third reason.

The obligation to charge posted rates interferes with the ability of a company to compete. They are deprived of maneuverability, of quick response time. One example of this, with which some people may be familiar, is the complaints that have been made by LOOP, the deepwater port off the Louisiana Gulf, about the adverse effect on its responsiveness, that derives from this obligation to continue to comply with tariff filing requirements, notwithstanding that it is functioning in a very competitive environment.

Finally, the third defect is that the obligation to file tariffs, that have been posted in advance, in a competitive context, is very, very likely to facilitate collusion among the sellers. Indeed, there are Supreme Court cases outside regulated areas that very wisely hold that the exchange of price data among competitors is a violation of the antitrust laws because it facilitates cartel behavior between the participants. And so, to require by law that parties participate in the very kind of data exchange that would be held anticompetitive in violation of the antitrust laws outside that area would be a very, very serious mistake. It is quite possible that we might deregulate markets which were potentially perfectly competitive, and then turn around and create market power problems in individual markets by requiring this kind of advanced posting of tariffs in an obligation to adhere to those prices.

If portions of this industry are effectively competitive, and we think many are, then deregulation in those portions should be complete. If there are substantial problems of market power, then a sensible regulatory regime should be retained. There is no doubt that that is true of TAPS. There may well be markets in the lower 48 States that answer that description, as well.

Turning to the study which we committed to some time ago, and have now largely completed, what we have done is, in the lower 48, we have attempted to look at each individual market, every crude origin market, every crude delivery market, every product origin and delivery market, all the many markets involved. In each of those markets, we have taken into account not only the extent to which there is competition from other pipelines, but the extent to which there is competition from local refining activities. That is an effective form of competition. In crude origin markets, for example, the extent to which there is local consumption of refined products is an effective form of competition in product origin markets. There are many different kinds of competition, depending on which of these types of markets one is looking. And we have attempted to take those all into account. The size of the markets that we are talking about are relatively small. We have used the Bureau of Economic Analysis, BEA regions, of which there are about 180 in the United States, as the markets for study.

We were induced to do that, in part, by data availability. There happened to be good economic data available for these BEA's, but the BEA's commend themselves to this kind of analysis because of their size, and the relationship of that size to the possibility of moving either crude oil or refined products by truck.

As the former witness indicated, quite correctly, in my view, trucking is an effective form of transport competition, but only over a distance of about 100 miles, and that corresponds, at least in a rough way, with the size of these BEA's, and commends them as appropriate geographic territories for study.

What we have done, basically, is to look at each of these different sources of competition in each of these many different markets, and attempted to make crude judgments about the probable effectiveness of competition, in view of those many or few choices that are available within each market.

We have essentially constructed a concentration index for each of those markets, using the same concentration index we use in evaluating mergers, the so-called Hirschman-Herfindahl Index. Basically what we are attempting to do is to create a first cut analysis across all these markets, which will be one step in a categorical approach that we think will enable us to say:

> Look, here is a large set of pipelines and pipeline companies that it is perfectly safe to deregulate. Let them go and do so in a very efficient, quick way, probably by rulemaking, so that all the pipelines that have the following characteristics are released from regulation.

That will keep still under regulation another group of pipelines, we do not know how many at this point in time. Very, very preliminary indications are that you can probably deregulate something like two thirds of the pipeline companies in the United States, companies which account for perhaps half of all throughput, with one stroke of the pen, simply by looking at these index numbers across the United States.

Then there would be a further and somewhat more focused administrative proceeding that would say:

> Now, there will be additional cases in here that are perfectly worthy candidates for deregulation, even though they did not pass the index test, because of specific circumstances, let us take a look at those. We will let some more go under that more focused administrative procedure. In the end, there will be some number—we do not know what number—of pipelines left under regulation.

One of the reasons the problem is complicated, and it reflects a question that one member of the subcommittee asked, is that a pipeline typically will serve a large number of markets. Some of the markets it serves are likely to be competitive, but in some of the markets it serves it may have a very significant degree of market power. Yet one must regulate an entire pipeline, one cannot, as a practical matter, regulate on a market-by-market basis.

So that one then has to make very pragmatic judgments about a pipeline which faces effective competition in most of its markets, but which has significant degree of market power in a few, whether you can justify the very expensive and distortive process of public utility type regulation with reference to the number of markets in which it continues to have market power.

I know of no way to avoid that kind of crude judgment that is based largely on an intuitive, rather than a scientific process, but the sad fact is that the practicality of attempting to regulate a portion of a pipeline is a very unsatisfactory effort. It really cannot be done as a practical matter.

I have a number of examples in my testimony that are intended, at least, to suggest to you the way we are going about this process and the nature of the index that we are talking about. I think that I will not actually attempt to go through them; they are there for you to read.

What I wish to stress is that in an effort to keep the paper reasonably short, we gave you very, very simple examples, which involve only pipeline market shares. In our study itself, we take into account not only pipeline market shares, but market shares attributable to local refineries, market shares available to other sources of competition, water transport, and so on.

We agree, incidentally, that water transport, where it exists, certainly ocean transport, is an effective means of competition, although barge lines are less so. But if our worst problems arose, where there was effective barge competition, there probably would not be very serious problems. The real difficulties are markets in which there are not alternative water sources—inland markets. The North Slope, of course, is a perfect example. Where you are dependent upon overland transportation, pipelines are so much more efficient transporters than are trucks or railroads, that the pipeline may be in a position to charge transportation prices that are very substantially in excess of its costs and still not lose the business to the next most efficient mode of transportation. That is precisely the phenomenon we call market power.

We do hope to have our study available for everyone soon. I wish to stress that the data that is relied on in those studies is the best we were able to get a hold of, but far from perfect. Some of it we suspect ourselves is rather out of date, and one of the things that I hope occurs as a result of releasing the study soon is that when people in the industry, or other people who have studied these problems, take a look at it and see the data that we have used, they will come running to us and say: "Look, the conclusions that you have reached in market number 175, are wrong, and the reason they are wrong is that your data is wrong, and let us give you some better data there."

We would be delighted, on each occasion, when that happens. In short, I am openly soliciting submission of superior data, wherever anyone has it, because we are quite aware of the data limitations which we confronted in doing this study. At the same time, I think I can say it is the best publicly available data, certainly the best we were able to find.

That is a quick overview, I suppose, of the problem as we see it, Mr. Chairman. I would prefer to stop there, and deal with any questions the subcommittee may have.

Mr. ANDERSON. Thank you, Mr. Baxter.

You referred quite a bit to this legislative study. Is that going to come in the form of a legislative proposal, or is it just a study?

Mr. BAXTER. No, I think it will be just a study. Certainly the one that will be released soon will be just a study.

Mr. ANDERSON. When do you mean by soon, like December, January?

Mr. BAXTER. No, I do not. I mean days, rather than weeks.

Mr. ANDERSON. In other words, within the next 2 or 3 weeks?

Mr. BAXTER. Yes.

Mr. ANDERSON. Then you will not be following that up with a legislative bill?

Mr. BAXTER. Well, we may be. But as I say, this is a study of markets, 181 individual markets. One of the things that we have not yet done is to approach this problem on a pipeline-by-pipeline basis, and see how many competitive markets, how many noncompetitive markets a given pipeline supplies, and attempt to make the highly pragmatic judgment about whether a sufficiently large number of those markets are competitive to justify letting the pipeline out of the regulatory system.

It is not that that problem is so difficult, although it is difficult. It involves a different kind of process than the more objective process in which we have been engaged so far, and that has not yet been done.

Mr. ANDERSON. Because the TAPS pipeline is an undivided interest pipeline, with each of its eight partners setting their own tariffs, and keeping their own books, the Barber report commissioned by several pipeline companies believes that it should be viewed as eight distinct pipelines, and so ought to be deregulated.

Now, you have said that deregulation of TAPS would be a serious mistake.

On what basis do you disagree with Mr. Barber's assessment?

Mr. **Baxter**. Well, it really is not eight pipelines. The point is that the rates could be raised to the advantage of the owners, and the consequence of increasing the rates would be to depress the value of the crude.

Now, insofar as a company has exactly the same percentage interest in the pipeline as it has of reserves, that is a wash to them. Insofar as it has a bigger interest in the pipeline than it does in the reserves, it comes out ahead by raising rates. Companies that have an interest in the reserves, but not in the pipeline, of course are injured by that process.

I can illustrate that proposition by suggesting that if the world price for North Slope crude is $30 a barrel, and the transportation charge from the North Slope is $30 a barrel, then the wellhead value of the crude is zero. It is valueless because it costs as much to get it south across Alaska, as it can be sold for at the transportation point.

So that the power to set rates on the TAPS pipeline is a power to determine the value of crude at the North Slope. Of course, that is also part of what the State of Alaska is worried about, because the State taxes, the royalties, and so on, are dependent upon the value of the product at the wellhead, but that is strictly a function of transportation costs.

So that the TAPS pipeline has enormous market power, but with respect to the value of crude, and therefore the incentives to explore, and the incentives to produce at the North Slope. The exercise of that market power could also result in higher prices for crude oil and petroleum products in downstream markets.

In short, the problem there is a crude origin market problem, not a crude delivery problem.

Mr. **Anderson**. Are there other areas in which you find fault with the Barber report?

Mr. **Baxter**. I have not read the Barber report recently enough to be able to respond to that question now, Mr. Chairman.

Mr. **Anderson**. Now, the previous witness indicated that if H.R. 2677 were enacted into law, the potential gray area would result with respect to the application of the Elkins' Act, in the discrimination provisions of the Interstate Commerce Act, to dividends paid by oil pipeline companies to affiliates.

Do you agree with that statement?

Mr. **Baxter**. Yes, I think so. Again, that is not a problem that I thought about specifically, in connection with this piece of legislation, but I would think that in any deregulatory legislation with respect to pipelines, that problem ought to be attended to, and I do not think it is attended to, at least it is my impression that it is not attended to by H.R. 2677.

Again, I would say that if there is no justification for rate of return regulation, then deregulation should be complete. Public utility type regulation is a very unsatisfactory governmental device. It can be justified where markets are far short of competitive standards, but it is very expensive.

What can never be justified are sort of the halfway houses to regulation. They are totally ineffective, expensive, cause their own distortions, and benefit no one. So that to the extent that the Congress finds that competition is adequate to justify eliminating rate of return regulation, all of the rest of the scheme should go with it.

Mr. ANDERSON. Would you make an estimate on the percentage of operating pipelines for which competition exists, and the percentage of crude, and refined products they carry?

Mr. BAXTER. I am very reluctant to try to do that. I am not even certain exactly what the question means, Mr. Chairman.

How am I to count pipelines? Are we talking about pipeline companies, are we talking about linear miles, are we talking about barrels of throughput. As I have already indicated, when you give me the answer to all those questions, I am going to point out that so far we have studied only individual markets, and pipelines usually are involved in a number of markets. It is very, very difficult to say.

I gave you a very, very quick and dirty estimate that in the first broad sweep approach, we probably will be able to let out the regulatory door something like two-thirds of the pipeline companies. That number perhaps account for something like half of the product and crude throughput.

Now, beyond that, I would simply be telling you more than I really knew, and I am reluctant to do that.

Mr. ANDERSON. I cannot quite understand that. It would seem to me that one of the first things you would know would be those pipelines for which competition exists, and those which you would think they would not.

Is that not kind of where you start in your business?

Mr. BAXTER. As I say, we started with 181 markets, either origin markets or destination markets, and it is those that we have studied and analyzed to this point. One must then go through the process of laying out the pipelines as they move through these markets, and seeing that here is a pipeline that is competitive in seven of its markets, but which appears to have some market power in the eighth, and asking what do we do about that pipeline.

Mr. ANDERSON. What would you group it with? Would you group it as one in which competition exists, or does not? Or is it a question mark or a mix? That would be the first way you would divide it. Those for which there is competition, those for which there is no competition, and those for which there is a mix, and then you ought to be able to tell us what percentage of the whole that would fall in each, and then divide them, as we said, into crude pipeline products.

Mr. BAXTER. Well, I regard that as the last step in the process, not the first. It seems to me that one has to know the conditions that exist in all of the individual markets first.

Now, if I found a pipeline that functioned in eight markets, and was competitive in seven, and had some degree of market power in the eighth, I would. Now, one of course must acknowledge the possibility that it delivers only 10,000 barrels in each of the first seven markets and delivers 10 million barrels in the eighth, so that the eighth market can perhaps dominate the first seven.

One must simply engage in a judgmental process, but certainly, in general, if the markets were comparable, I would think the value of getting a pipeline that served eight markets, faced effective competition in seven, and had some degree in market power in the eighth, out from under regulation, would justify letting such a pipeline out of the system.

That, however, is clearly a judgment call of a different kind than the technical matter of measuring concentration in markets.

Mr. ANDERSON. Well, I suppose that is where we are trying to get a handle on where you are coming from. It would seem to me if you do have this kind of situation, and you do have to make that judgmental decision, you ought to be telling us why and how you are doing it, so that we can group them, and know what the Department of Justice means.

Mr. BAXTER. I quite agree, Mr. Chairman. I am not suggesting, for a moment, that we are not going to do that. All I mean to tell you is that at this point in time, although we have studied the individual markets, we have not gone through that step of the process. We will go through that step of the process, we will make these judgments, we will be anxious that the subcommittee understand the nature of the judgments that we made on a pipeline-by-pipeline basis, and we will communicate that to you, but we are not ready to do so today.

Mr. ANDERSON. Mr. Shuster?

Mr. SHUSTER. Thank you, Mr. Chairman.

We certainly appreciate your testimony, Mr. Baxter.

Do I understand you correctly, that you see deregulation taking two steps, the first step being what we might call deregulation by index?

You would establish an index, and on the basis of that index, those pipelines that met the criteria would be deregulated. So that means we would be putting into the law an index, which would trigger deregulation, is that fair?

Mr. BAXTER. That is fair, that is certainly one way you might do it. Another way you might do it is simply authorize somebody to set an index number of a type, perhaps within a range, and to make the pipeline-by-pipeline judgments that I have tried to describe, rather than the market-by-market judgments.

Mr. SHUSTER. And then, of course, the second step, if I understand you correctly, would be by administrative procedure?

Mr. BAXTER. Yes, but certainly you are right, what we have in mind is one broad sweep based on the kind of data that I have been talking about this morning, that would let a large faction of the industry out from under regulation, and then another, second round of more focused inquiries, that would let some further companies out from under regulation.

Mr. SHUSTER. I would respectfully suggest that my view, it is extremely important that once you have your study done, you convert your recommendations into legislative language recommendations, because I think this member, and perhaps other members get nervous when you think about writing into the law an index which is going to be the basis upon which decisions are going to be made.

And so I think we would have to be reasonably comfortable that it is going to work, and I would urge you to turn your conclusions into specific legislative language for us to consider. It seems to me that that is just vital.

Mr. BAXTER. We had in mind doing that, working with other agencies in the executive branch, Energy, obviously, and to do that.

But our feeling was that that could be done only after we had finished the analysis.

Mr. SHUSTER. Right.

Thank you very much.

Mr. ANDERSON. Mr. Breaux?

Mr. BREAUX. Thank you very much for your testimony. I like your phrase that it is kind of a halfway house for deregulation. And in the sense that you have some concerns that if we are going to deregulate the oil pipelines, that as far as ratemaking is concerned that we should also do it as far as discrimination and access, et cetera. So you do not want to build a standard there, at least you do not want one deregulated and one continued to be subject to FERC.

What about your suggestion that we have what I think is a two-tiered standard that you were suggesting with regard to deregulation as far as pricing is concerned, that you would deregulate some but not all? Are you not saying that you are going to deregulate it or, if someone makes a determination to have competition but where you do not, you are going to continue to have some source of regulation there? Is that not a two-tiered system?

Mr. BAXTER. No, not at all in the same sense. We make distinctions in everything we do. We have regulation for electrical utilities but not for shoe manufacturers.

Mr. BREAUX. Of course we are talking about the same industry here and carrying the same product.

Mr. BAXTER. Well, the definition of an industry is quite arbitrary. I mean, I can readily say no, there are really two industries. There is a set of natural monopoly pipelines and that is one industry, and there is a set of competitive pipelines and that is another industry.

The circumstances of the pipelines differ and we are suggesting regulatory treatment that is appropriate to the circumstances of the individual pipeline. I see nothing invidious about that kind of judgmental discrimination.

Mr. BREAUX. I appreciate the fact that the Government is doing a study on the regulated oil pipelines and I am looking forward to receiving it, but why are we not doing a similar study to that means of transportation that is not subject to any regulation? Meaning the water transportation.

Mr. BAXTER. No, because water transportation is effectively competitive. There is no reason to think that there is even an isolated barge line that has any substantial degree of market power.

Furthermore, if the pipelines are the major supply factors—I could make the same point about the origin markets, but I will make it with respect to the destination markets—if a pipeline delivers the preponderance of products to a city and if it has the capacity to deliver even more, and it is effectively regulated so that its rates are controlled to correspond to its costs, including the fair rate of return, then one does not need to incur the expense of regulating anybody else. Because the availability of product through the pipeline at a competitive price is a circumstance which in and of itself constitutes effective regulation for everybody else. So that I find nothing peculiar at all about the circumstance you seem to find so troublesome; namely, that we regulate pipelines and not bargelines. It makes perfectly good sense to me.

Now, I would say that——

Mr. **BREAUX**. How are they identifying troublesome? I just made the observation. It does not give me a lot of heartache.

Mr. **BAXTER**. Right. Heartache I understand, but perfectly sensible government is something other than heartache.

Mr. **BREAUX**. What are we going to do, Mr. Chairman, go and vote and come back?

Mr. **ANDERSON**. Do you have more questions?

Mr. **BREAUX**. The only other point I had was about the publishing of the tariffs. I appreciate how that could cause problems. I am trying to help correct it with regard to LOOP now.

But what we envision is a short, I think a short tariff, that could be effective perhaps only for 30 days, that could be changed after 30 days to be adjusted to the market situations.

Would that still be troublesome?

Mr. **BAXTER**. It would be troublesome in both senses. It would cut down their flexibility to respond to competitive circumstances. Thirty days is a long time. But what would concern me even more is the extent to which it would facilitate collusion among and between pipelines serving common markets.

Mr. **BREAUX**. Do we not have that now when a rate is approved by FERC? Everybody has the same rate?

Mr. **BAXTER**. Yes, but the rates are set so that we do not have to worry about them behaving as a cartel, at least we tell ourselves we do not. And it is quite something else when rates are unregulated, and on top of that you provide this collusion facilitating mechanism.

Mr. **BREAUX**. I think we are out of time. We can pursue that another time.

Mr. **ANDERSON**. Well, we are going to recess now.

Mr. Baxter, when you complete your study, we want to see it so that we can submit questions to you on the study after we get your study.

Mr. Baxter, and Mr. Brown, thank you for your presentations.

We will now recess and go to vote, and we will reconvene here at 1 o'clock this afternoon. It will give you all time to go to lunch.

[Whereupon, at 11:55 a.m., the subcommittee recessed, to reconvene at 1 p.m., the same day.]

AFTERNOON SESSION

Mr. **ANDERSON**. The subcommittee will come to order.

Our first witness this afternoon is the Honorable Christopher C. DeMuth, Administrator of the Office of Information and Regulatory Affairs of the Office of Management and Budget. Mr. DeMuth, we do have your prepared statement here. It will be made a matter of the record in its entirety at this point.

[Statement referred to follows:]

STATEMENT OF CHRISTOPHER DEMUTH, ADMINISTRATOR FOR INFORMATION AND REGULATORY AFFAIRS, OFFICE OF MANAGEMENT AND BUDGET

Chairman Anderson and Members of the Subcommittee, I appreciate this opportunity to discuss the Administration's views on oil pipeline deregulation. We are heartened by the interest this Subcommittee is showing in the issue through these hearings on H.R. 2677, the Oil Pipeline Regulatory Reform Act of 1983.

The Administration agrees with the primary purpose of H.R. 2677. There is today a clear and present danger that public-utility type regulatory controls will be extended to virtually the entire oil pipeline industry. The industry, however, is substantially competitive in structure, and we know from long and hard experience that, in this situation, regulation is likely to produce substantial economic inefficiencies and harm producers and consumers alike. It is time to eliminate the unnecessarily broad and expensive controls on oil pipelines that have been part of federal law (though largely dormant in practice) since the days of Roosevelt and Rockefeller.

We believe, however, that H.R. 2677 would go too far in one respect, and not far enough in another, in accomplishing this task. It would remove rate controls from all pipelines regardless of market circumstances, while retaining common carrier status and anti-discrimination controls for all pipelines. There are, however, a limited number of pipelines in the lower forty-eight states, and the Trans-Alaskan Pipeline System (TAPS) that continue to possess substantially greater market power than other pipelines; federal policy should not ignore these important differences in the market positions of indivudual pipelines. At the same time, common carrier status and anti-discrimination controls are so closely related to rate regulation that there is no good reason for retaining them where rates are deregulated. In our view, oil pipeline legislation should retain regulation for those pipelines possessing true monopoly power—while removing regulation swiftly and completely for the majority of lines operating in competitive markets.

As a general matter, we believe that federal regulatory controls should be imposed only where all three of the following conditions exist: First, where private markets exhibit serious inefficiencies that are based upon a record of fact rather than theory. Second, where these inefficiencies cannot be adequately addressed by state or local government. And third, where it seems likely that regulatory controls will yield a true net improvement in the performance of the market—that is, where the benefits of regulation will clearly outweigh its costs.

This last condition is of particular importance. In the past, advocates of regulation have tended to focus almost exclusively on inefficiencies—often theoretical—in the private marketplace, and to ignore the inefficiencies of the regulatory process itself. A more balanced approach is to recognize that while markets are seldom "perfect," regulatory controls are seldom perfect either. This is particularly true with respect to the type of traditional economic controls at issue here today—where government agencies decide at what price, and under what conditions companies can do business.

A generation of studies by economists, industry groups, and government agencies have demonstrated that controls have been applied as often to competitive markets as to monopolies, and that even in non-competitive markets they have often made matters worse rather than better. Regulatory officials typically lack the kind of detailed and up-to-date information on market demand and costs necessary to determine efficient prices that properly balance the interests of consumers and investors. Indeed, the entire process of rate-of-return regulation typically comes down to guesswork and political compromise rather than any kind of scientific "expertise."

The economic structure of the oil pipeline industry has been the subject of several recent studies. While one may debate particular aspects of these studies, I believe there is little doubt about their essential conclusion—that most of the industry is and will remain competitive.

This competition occurs in several ways. Pipelines compete with other pipelines, both parallel lines and other "spokes" serving the same market. They also compete with water transportation; barges and tankers move almost half of all refined products and about two-fifths of all crude oil. Pipelines compete with local sources of oil products—local refiners and nearby crude production. Finally, competition in the markets for crude and refined products exerts a constraint on transportation prices which constitute a small fraction of the final product price, or (excluding TAPS) about 1.3 percent of the nation's oil bill.

Despite these general characteristics, there are some situations of local monopoly in the oil pipeline industry—where a particular pipeline is substantially unconstrained by competition from other pipelines, other transportation modes, potential new entry, or product markets. It is here that we must bear in mind the caveat about weighing the costs of market imperfections against the costs of government regulation. Occasional instances of monopoly do not justify aiming the full artillery of regulatory controls at an entire industry; if they did, virtually would have to be controlled out of Washington. Even in those situations where there is an extremely high market concentration, regulation may not be economically worthwhile. Several conditions may exist which make regulation ineffective or unnecessary. These include bottlenecks elsewhere in the distribution chain and vertical integration (common in this industry) between pipeline owners and their suppliers or customers.

During the past year we have been working with the Departments of Energy and Justice to develop a detailed Administration proposal for deregulating oil pipelines. The Justice Department is completing a careful study of market concentration in the oil pipeline industry which should be very helpful in determining which pipelines should be deregulated. We believe that we have developed an approach which will make the best use of the competitive markets which exist in the great preponderance of the pipeline industry, while retaining regulatory protections for those markets which are not competitive and where such regulation would be cost effective.

We will propose a statute which defines guidelines for the Executive Branch to apply in deciding which particular pipeline markets to regulate. These guidelines must reflect two distinct criteria. The first criterion should be a measure of market concentration and market power, including all potential sources of competition. This criterion should serve as a necessary, but not a sufficient cause for regulation. The second criterion should be a weighing of the costs and benefits of regulation under the specific circumstances. This should include considerations of the probable effectiveness as well as the likely costs of imperfect regulation. The statute should require an informal administrative process to determine which cases clearly do not warrant continued regulation. As a result of the Justice study, it is clear to us that statutory tests based on a combination of monopoly power and the likely cost-effectiveness of regulation should result in at least two-thirds of the pipeline companies representing about one-half the industry throughput being quickly deregulated. The remaining pipelines should also be eligible for deregulation at any time, but only after a more detailed administrative process.

Under this scheme, an initial administrative decision would be made to lift all regulatory controls on pipelines operating in clearly competitive markets and on pipelines where regulation would not be a cost-effective response to market concentration. The remaining pipelines—including those that the Justice Department study suggests are strong candidates for continued regulation and a few "close cases" that may turn upon particular new evidence—would then be subject to more extensive case-by-case determinations. The end result would be that a relatively small number of market-dominant pipelines should remain subject to the current regulatory authorities of the Federal Energy Regulatory Commission, while all others would be entirely deregulated and subject to the antitrust laws in the same manner as the rest of private industry.

We are still working out the details of this proposal, but expect to have a final document prepared very shortly. We will of course work closely with the Members and staff of this Subcommittee, and others in the House and Senate, to reach agreement on a bill that will earn wide congressional support and passage this session. I would note that the approach I have sketched here is about midway between two recent deregulatory laws—the Airline Deregulation Act of 1978, which deregulated (on a phased basis) all domestic airline markets as a matter of statute, and the Staggers Rail Act of 1980, which authorized market-by-market administrative deregulation under a specific statutory test. We believe the circumstances of the oil pipeline industry warrant this midway approach of immediate deregulation of most pipeline markets plus case-by-case administrative determination for the rest.

While we support deregulation of most pipelines in the lower forty-eight States, we have concluded that the current regulatory structure should be retained for the TransAlaskan Pipeline System (TAPS), which is a special case. Monopolistic pricing of TAPS' facilities could adversely affect non-pipeline owners' plans for lease purchases, exploratory drilling and production on the Alaskan North Slope—an area with large, untapped petroleum reserves.

In sum, Mr. Chairman, the Administration supports complete deregulation of oil pipelines except for TAPS and other cases where substantial local monopolies can be proven and rate regulation will be effective. We believe this would be a major step in retrieving energy markets from the stultifying federal regimentation that grew up during the 1970s—and making this crucial economic sector more free, competitive, and productive. Opening these regulated markets to competition will result in real benefits to the consumers of oil products, the American public.

Thank you very much.

Mr. ANDERSON. Please proceed.

TESTIMONY OF HON. CHRISTOPHER C. DeMUTH, ADMINISTRATOR, OFFICE OF INFORMATION AND REGULATORY AFFAIRS, OFFICE OF MANAGEMENT AND BUDGET

Mr. DEMUTH. Mr. Chairman, thank you very much. I am delighted to be here this afternoon to discuss the administration's views on oil pipeline deregulation.

We are heartened by your interest and that of your colleagues in this issue through these hearings on H.R. 2677, the Oil Pipeline Regulatory Reform Act.

The administration agrees with the primary purpose of this bill. There is today a clear and present danger that public utility type controls will be extended to virtually the entire oil pipeline industry.

But the industry is substantially competitive in structure, and we know from long and hard experience that in a situation such as this, regulation is likely to produce substantial economic inefficiencies, and harm producers and consumers alike.

It is time to eliminate the unnecessarily broad and expansive controls on oil pipelines that have been a part of Federal law since the days of Roosevelt and Rockefeller.

In our view, however, H.R. 2677 would go too far in one respect, and not far enough in another respect in accomplishing this task. It would remove rate controls from all pipelines regardless of market circumstances, while retaining common carrier status and antidiscrimination controls for all pipelines.

There are, however, a limited number of pipelines in the lower 48 States, as well as the Trans-Alaskan Pipeline, that continue to possess substantially greater market power than other pipelines.

Federal policy ought not to ignore important differences in market positions of individual pipelines as large as we believe exist.

At the same time, common carrier status and antidiscrimination controls are so closely related to rate regulation, that there is no good reason for retaining them where rates are deregulated.

In our view, oil pipeline legislation should retain regulation for those pipelines possessing true monopoly power, while removing regulation swiftly and completely for the majority of lines operating in competitive markets.

As a general matter, we believe that Federal regulatory control should be imposed only when three conditions exist. First, where private markets exhibit serious inefficiencies that are based upon record fact rather than theory. Second, where these inefficiencies cannot be adequately addressed by State or local governments. Third, where it seems likely that regulatory controls will yield a true net improvement in the performance of the market, that is, where the benefits of regulation will clearly outweight its costs.

This last condition is of particular importance. In the past advocates of regulation have tended to focus almost exclusively on inefficiencies, often theoretical, in private markets—while ignoring the inefficiencies of the regulatory process itself.

A more balanced approach is to recognize that while markets are seldom perfect, regulatory controls are seldom perfect either. This is particularly true with respect to the type of traditional economic controls at issue here, where Government agencies decide at what price and under what conditions companies can do business.

These controls have been applied as often to competitive markets as to monopolies, but even in noncompetitive markets they have often made matters worse rather than better.

Regulatory officials typically lack the kind of detailed, up to date information on market demand and costs necessary to determine efficient prices that properly balance the interests of consumers and investors.

The entire process of rate-of-return regulation typically comes down to guesswork and political compromise, not any kind of scientific expertise. And the record of oil pipeline regulation provides particular testimony to that fact.

The economic structure of this industry has been the subject of several recent studies, and while one may debate particular aspects of each of them, I believe there is little doubt about their essential conclusion: That most of the industry is and will remain competitive.

This competition occurs in several ways. Pipelines compete with each other, both with parallel lines and with other spokes serving the same destination markets. They also compete with water transportation. Barges and tankers move almost half of all refined products, and about two fifths of all crude oil. Pipelines compete with local sources of oil products, local refineries, and nearby crude production.

Finally, competition in the markets for crude and refined products exerts a constraint upon transportation prices which constitute only a small fraction of the final product price, or excluding TAPS, about 1.3 percent of the Nation's oil bill.

But in spite of these general characteristics, there are some situations of local monopoly in the industry where a particular pipeline is substantially unconstrained by competition from other pipelines, other transportation modes, potential new entry, or product markets.

It is here that we must bear in mind, however, the caveat about weighing the costs of market imperfections against those of Government regulation itself. Occasional instances of monopoly do not justify aiming the full artillery of regulatory controls at an entire industry. If they did, virtually every industry would have to be controlled out of Washington.

Even in those situations where there is extremely high market concentration, regulation may not be economically worthwhile.

During the past year, we have been working with the Departments of Energy and Justice to develop a detailed administration proposal for deregulating oil pipelines. The Justice Department is completing a careful study of market concentration in the oil pipeline industry which will be very helpful in determining which pipelines should be deregulated.

We believe that we have developed an approach which will make the best use of the competitive markets which exist in the great proponderance of the pipeline industry—while retaining regulatory protections for those markets which are not competitive, and where such regulation would be effective.

We will propose a statute which defines guidelines for the executive branch to apply in deciding which particular pipeline markets to regulate, and which to deregulate. These guidelines should reflect two distinct criteria. The first is a measure of market concentration and power, including all potential sources of competition. This criterion should serve as a necessary but not sufficient cause for regulation. The second is a weighing of the costs and benefits of regulation under specific circumstances. This should include considerations of the probable effectiveness as well as the likely costs of imperfect regulatory controls.

The statute should require an informal administrative process to determine which cases clearly do not warrant continued regulation. As a result of the Justice study, it is clear to us that statutory tests based upon a combination of monopoly power and the likely cost effectiveness of regulation should result in at least two thirds of the pipeline companies, representing one half of industry throughout, being deregulated essentially immediately.

The remaining pipelines would also be eligible for deregulation at any time, but only after more detailed administrative review.

Under this scheme, an initial administrative decision would be made to lift all regulatory controls on pipelines operating in clearly competitive markets, and on pipelines where regulation would not be a cost effective response to market concentration.

The remaining lines—include those that the Justice Department study suggests are strong candidates for continued regulation, and a few close cases that may turn upon particular new facts—would then be subject to more extensive case-by-case determinations.

The end result would be that a relatively small number of market dominant pipelines would remain subject to the regulatory authorities of the Federal Energy Regulatory Commission, while all others would be entirely deregulated and subject to the antitrust laws in the same manner as the rest of private industry in the United States.

We are still working out the final details of this proposal, but expect to have a final document prepared very shortly. We will work closely with the members and staff of this subcommittee and others in the House and Senate to reach agreement on a bill that will earn wide support and passage in this Congress.

I would note that the approach I have sketched here is about midway between two successful recent deregulatory laws: The Airline Deregulation Act of 1978, which deregulated all domestic airline markets as a matter of statute, and the Staggers Rail Act of 1980, which authorized market by market administrative deregulation under a specific statutory test.

We believe the circumstances of the oil pipeline industry warrant this midway approach of immediate deregulation of most pipeline markets, plus case-by-case administration determination for the rest.

In summary, the administration supports complete deregulation of oil pipelines except for TAPS and other cases where substantial local monopolies can be proven, and where rate regulation will be effective.

We believe that this would be a major step in retrieving energy markets from the stultifying Federal regimentation that grew up during the 1970's and making this crucial economic sector more free, competitive, and productive.

Opening these regulated markets to competition will result in genuine benefits to the consumers of oil products, the American public.

We look forward to working with you, Mr. Chairman, and with your colleagues in fashioning workable legislation to accomplish this end. Thank you very much.

Mr. ANDERSON. Thank you, Mr. DeMuth.

Mr. ANDERSON. Mr. DeMuth, on page 5 of your statement you say that—

> We will propose a statute which defines guidelines for the executive branch to apply in deciding which particular pipeline markets to regulate.

Can you give us any indication which part of the executive branch will be designated to implement the guidelines?

Mr. DEMUTH. We have some more work to do on this internally. I think it would be an administrative process involving both the Justice and Energy Departments.

The important thing will be coming up not only with a procedure, but a statutory formula which Members of Congress can look at and have a relatively clear idea of which parts of the industry would be subject to prompt deregulation, and which parts were more problematic and would require more thorough adjudicative review before a final decision could be made.

Mr. ANDERSON. Do you think it would be the Justice Department, or FERC, or who do you think might be doing it?

Mr. DEMUTH. I would think that it would probably not be FERC, since FERC would be the agency that would engage in the price regulation of the lines that were left.

The essential point that I would like to emphasize is that we believe that the clean-sweep approach of H.R. 2677 is not sufficiently discriminating, and that the Justice Department study will suggest that there are a few limited instances where continued Federal involvement is appropriate.

From what we've seen so far, we think this issue is serious enough to justify developing a careful statutory procedure for making the proper distinction between the vast majority of pipelines which are competitive, and those few which are not, is worth investing.

Mr. ANDERSON. Do you have any data that might forecast what will happen to oil pipeline rates if they are deregulated?

Mr. DEMUTH. I think that we can say with a high degree of confidence that, looking broadly across the United States, oil pipeline rates will either remain the same or will go down.

Every time there is a deregulation proposal up before the Congress, opponents claim that prices will go through the roof if the Government averts its beneficent gaze from the pricing mechanism. And we know in several recent instances that those predictions turned out to be wrong.

It was wrong in airline deregulation; it was wrong in trucking deregulation; it was wrong in petroleum deregulation. I suspect it will be wrong here as well.

Given that this industry is largely a competitive one, there is little that the Government has to offer over natural market incentives in keeping prices down to costs of production.

About all the regulations have to offer is overhead and litigation and other unnecessary costs, which amount to perhaps $50 million in just the administration of the FERC program at present.

Doing away with these and other inefficiencies that regulation introduces into these markets is very likely to result in lower costs and lower prices.

Mr. ANDERSON. Have you made any estimates as to the amount of revenues that might be lost to the Federal Government in the form of windfall profits tax if the pipeline industry were deregulated?

Mr. DEMUTH. No, sir, I have no figures on that, but my understanding is that this is something that does not worry the Department of the Treasury. The definition of what is taxable income is something that the revenue agents have a certain amount of discretion over. A firm's description of what constitutes income to what part of the enterprise would not be despositive, here as in so many other areas, because they would be the first people to let us know.

As for particular details, I think we probably ought to ask them.

Mr. ANDERSON. Well, it seemed to me that the OMB ought to know the answer to this, too, before they take a position on the proposal. We would like to get the estimated amount of Federal tax that either might be lost or not.

Mr. DEMUTH. I agree.

Mr. ANDERSON. Either you ought to get it for us, or Treasury Department should get it for us. You don't think you're the one that should get it for us?

Mr. DEMUTH. No, I would be delighted to if you want me to.

Mr. ANDERSON. All right.

[The information received from Mr. DeMuth follows:]

SUPPLEMENT TO TESTIMONY OF CHRISTOPHER DEMUTH ON H.R. 2677

THE EFFECT OF OIL PIPELINE DEREGULATION ON FEDERAL REVENUES

After having consulted with the Treasury Department, OMB confirms that the effect on Federal revenues of oil pipeline deregulation, as supported by administration witnesses, would be negligible.

The administration witnesses testified that for the majority of pipelines, sufficient competition (or potential competition) exists to prevent monopoly rates from being charged after deregulation. Those pipelines that possess substantial market power should continue to be regulated. If the rates charged by a pipeline could affect significantly the wellhead price of crude oil in its service area, for example, that would evidence a need for continued regulation of that pipeline. Such selective deregulation would therefore not induce major changes in oil prices or in the tax liability of pipelines and pipeline customers.

It is possible that small price adjustments after deregulation would result in minor revenue losses in some cases; in other cases the increased efficiency of deregulated competitive markets would result in small revenue gains through the Windfall Profits Tax. The most important potential gains would likely be associated with increases in domestic crude oil production that might be encouraged by the deregulation of new pipelines. The net effect is small and at present unquantifiable.

In cases where a deregulated pipeline was a subsidiary of one (or more) of its customers, the IRS would need to assure that the firms did not use artificial transfer prices as a way of reducing tax liability. This is a common situation in corporate tax law, and should not create any special problems in the case of pipelines.

The above conclusions apply only to deregulation proposals that take into account the market power that some pipelines possess. If deregulation were extended to all pipelines, including the Trans-Alaska Pipeline System and any lower-48 pipelines that were found to possess substantial market power, the effect on Federal revenues could be more significant. An estimate of the size of this effect would require far more data than are currently available.

Mr. ANDERSON. Mr. Shuster.

Mr. SHUSTER. I have no questions, Mr. Chairman. I concur with your line of questioning.

Mr. ANDERSON. Mr. Breaux.

Mr. BREAUX. Thank you very much, Mr. Chairman, and thank you, Mr. DeMuth, for the statement.

I get the impression that maybe what you're thinking about, although you haven't said it yet, is some sort of an application type of petition from the companies which would be seeking deregulation. Is that what we're talking about in deciding whether some would be deregulated or all would be deregulated, an idea of companies coming in and saying we think there's sufficient competition in our area, and we're seeking deregulation and decontrol in this particular area because of the following factors? And then someone in the Government deciding whether those factors justify deregulation?

Mr. DEMUTH. Sir, in our view, that approach would be more cumbersome than the facts of this case warrant. In our view a very large portion of the industry is so clearly competitive that we could have a very prompt administrative procedure where the burden of proof would not be on the pipelines to justify deregulation. And the nature of the pipelines that would be affected by that procedure would be something that the Members of Congress would understand at the time the law was passed.

So that either through some kind of administrative discretion or informal rulemaking a very large part of the industry could be deregulated within a month or two of the effective date of the act, without any applications from private parties or any case by case adjudication at all.

That would leave for case-by-case adjudication those lines where the economic evidence suggests serious potential monopoly problems. But even these cases need not be left to pipelines making a formal application.

Mr. BREAUX. Then following that theory, your testimony indicated that immediately you thought that perhaps a two third—one third split would be a possible scenario, for those that would remain under your suggestion or concept as still regulated. Do you envision a procedure whereby they would be able to come in and present testimony or evidence that would indicate that in fact competition does exist in that area to justify deregulation?

Mr. DEMUTH. Yes, sir, I do. But the statute could set the process in motion without some administrative law judge having to wait for somebody to come through the door with a petition. The statutory procedures could be self-executing, so the Justice and Energy Departments could get the ball rolling as soon as the law was passed.

Mr. BREAUX. With regard to making a determination as to whether there is sufficient competition in an area, I could envision situations where you look at a particular State that perhaps has maybe only one oil pipeline carrying a product to that particular State. Or some States have none, as far as crude oil carriers are concerned.

And I guess if you looked at that on its face you would say:

> Well, that's certainly a monopolistic practice. Perhaps there's only one because the business can only justify one, or perhaps it's just a terrible thing for a company to build a pipeline in that State; maybe there's water transportation or rail or some other form of transportation that more than adequately serves that area.

And in making the determination of whether an industry could justify being deregulated, what factors would go into that determination? The fact that there is only one pipeline I would assume does not necessarily ipso facto preclude it from being deregulated?

Mr. DEMUTH. Absolutely not. That would be the bare beginning of the analysis rather than the end. As I mentioned in my testimony, competition from water carrier and truck transportation and competition in the final product markets themselves can all place sharp constraints on pipeline pricing.

The fact that one pipe is running from A to B is interesting, but it's just the beginning. In itself it tells you little about the actual extent of market competition.

Mr. BREAUX. It seems if we take the approach the administration is suggesting, if I found myself in the one third category, say, that would be recommended for continued regulation, that it would seem that that would be a real discouragement for additional competition in that particular area.

If I was a company that was in the pipeline business, and after this initial determination was made, I think they would be hesitant to want to go into that regulated area and provide competition knowing its a regulated area. Why should they provide additional competition in an area that is going to be determined by the Federal Government as to what I can charge, what's my rate of return. And it would seem that that determination would be stifling any potential future competition in that area.

Mr. DEMUTH. I don't think that the initial determinations should be conceived as set in concrete. Markets change dramatically over time, and——

Mr. BREAUX. I know that's true in theory.

Mr. DEMUTH. A market may be highly concentrated, but if due to new pipeline or other forms of competition the market becomes competitive over time, the pipeline should then get out of regulation altogether.

Mr. BREAUX. I know that, and that's fine in the theoretical world. But if you're a person that's got to make some dollar decisions on building a pipeline, and you see the Government has determined that this is an area that's going to be regulated, and you're deciding whether to build a pipeline to service an area that is deregulated and decontrolled, or one that is going to be regulated, it would seem that it would be a real impediment to making that decision to go into that area, knowing that I'm going to have to get in there, I'm going to have to provide them competition, through FERC, and then maybe if I provide enough competition one day we might have a chance after paying a lot of lawyers a lot of money for a long period of time, we might have a chance of being decontrolled in that area.

I'm really concerned if we create these two classes of pipelines that we're going to be really stifling the competition in that second category.

Mr. DEMUTH. I did not mean to sound so theortical, and I think that the practical considerations you raise are extremely important. They are the primary reasons why regulation has to be applied with a very light hand, and the burden of proof for continuing Government regulation in any of these markets has to be extremely high.

A little bit of market power here and there is one thing, but when the Government gets in the act and causes all sorts of uncertainties and distortions in private investment decisions, the social costs of regulation can be much greater than the social costs of private monopoly.

This is why we have to be quite reluctant to continue regulation and ought to do so only where there is a whopping degree of monopoly power that simply cannot be ignored. This is exactly the approach we are working on.

Mr. BREAUX. Your position and the position of the other witnesses this morning is for deregulation with regard to rate making, but also to go a step further than the bill that I've introduced with others goes with regard to common carrier and antidiscrimination entry into the market.

And I'm not sure I understand why. I guess again in theory if you're going to be a purist, you're going to decontrol and deregulate everything, discrimination, common carriers, as well as rates.

Perhaps the only reason why we're continuing it is because of the political assistance that is provided by being able to tell those who are against decontrol, well, it's still a common carrier. You've got to let everybody use it. And still you cannot discriminate with regard to your rates; it maybe helps us sell the bill.

I'm not sure that I understand, and I would like you to elaborate a little bit on your statement that the common carrier status and antidiscrimination controls are so closely related to rate regulation that there is no good reason for retaining them where your rates are deregulated.

Mr. DEMUTH. I think there are four reasons, only some of which have been touched upon so far, which argue strongly for that position.

First, the three kinds of regulatory controls—rate regulation, common carrier regulation, and antidiscrimination regulation—are all justified by the same condition, private market power.

If I do not have enough market power to set monopoly rates, then I do not have enough market power to discriminate or any incentive to deny access. If I am operating in a competitive market, I cannot discriminate; I cannot turn you down or charge you higher than the next customs because you'll just go to one of my competitors. The threat of discrimination is completely ineffective unless the supplier has some degree of monopoly power.

Mr. BREAUX. OK. How about common carrier status?

Mr. DEMUTH. Denying you access is simply a technique of price discrimination. If my rates are determined by the market and will cover my costs if I serve you, then I will not turn you down.

Mr. BREAUX. But isn't it a different situation to some extent when you have the vertical integration of the companies that are in fact shipping oil? In other words, if I own the product, or I own a company that is happening to be shipping the product, can I not obtain an economic advantage by agreeing to ship my product or my subsidiary's product, but not my competition's product?

Mr. DEMUTH. No, sir. I believe not. If the market is competitive and I am integrated but you are not, I still will or will not transport your product at a given rate according to the same circumstances that would govern if I were not integrated.

Mr. BREAUX. But not if my long term economic interests is to beat the pants off you in the marketplace. Take an Exxon and a Shell, just for name's sake, and Exxon owns, I'm not sure if the companies own pipelines—I'd have to look at a list to see.

But say I'm Exxon, and say I own a pipeline company. Would it not be more in my interest to assure that Exxon gets the first access to that line and not to have Shell have any access to it because after all I'm interested in seeing Exxon succeed as oppose to Shell?

Mr. DEMUTH. If a firm was using its integrated structure to attempt to monopolize the upstream or downstream market, this would remediable under the antitrust laws.

Mr. BREAUX. But they're much more complicated.

Mr. DEMUTH. No, I think it would be essentially the same thing. Vertical integration is commonplace in American industry, and does not, in itself, justify economic regulation of the sort we are discussing here.

Mr. BREAUX. But wouldn't that company be able to argue that look, we're deregulated. I have the right to do that. I have the right to ship my product over their product because the law says I do not have to be a common carrier. Couldn't they make a pretty good argument in that sense?

Mr. DEMUTH. Well, there are several answers to that.

They would certainly be able to make that argument, and in many circumstances it would probably be a good argument. But there are cases where some shippers, especially smaller ones, have made cases that seem to me to be ones that we ought to be concerned about. But these cases should not be harder to bring under the antitrust laws. That is the conventional remedy for discriminatory treatment by vertically integrated firms in order to monopolize one market. For most industries that is the remedy that is used where somebody is engaging in that kind of practice.

In addition, in the case of oil pipelines, almost all of them are common carriers at common law, because they were built with the use of the States' eminent domain powers. And to that extent, a claim would lie at State common law.

Third, although we hear about these complaints, the fact is——

Mr. **Breaux**. Wait, on the second point, you're saying that because Congress determines that all interstate pipelines carrying oil would not have to be common carriers, that if a State said that an interstate pipeline was a common carrier, that they would be governed by the State laws regarding interstate pipelines?

Mr. **DeMuth**. If the pipeline in a given State had been built with the eminent domain powers of that State, the portion of it in the State would be a common carrier at that State's law.

Mr. **Breaux**. That would not potentially present an undue burden on interstate commerce? You would be restricting interstate carriage of a product in a manner that the Federal law would say that you do not have to do.

Mr. **DeMuth**. The fact that a method of transportation is involved in interstate transportation does not mean that the States have no remedies at all.

States everyday make decisions with regard to all sorts of transportation modes which affect interstate commerce. Whether a given act of a given State is placing an undue burden on interstate commerce depends on the facts of the individual case.

The fact is that shipper complaints about access and discrimination have been extremely rare in the 80-year history of the oil pipeline industry.

People were thrashing around looking for some examples this morning, and they could think of maybe two or three.

I think that is a very good indication of the essentially competitive nature of the industry.

Mr. **Breaux**. Maybe they were rare because they were being regulated. It was against the law to do it.

Mr. **DeMuth**. No, I'm saying the regulatory——

Mr. **Breaux**. We're making it legal to do it, and I'm not sure that that wouldn't allow it.

Mr. **DeMuth**. I don't know how hard you want to press that argument. In lots of regulatory programs, there have been hundreds of cases. Hundreds of cases in the railroad and electricity distribution and telecommunication industries a handfull of them here.

My view is that the reason complaints have been so rare here is that the industry is essentially competitive, not that these obscure laws have forced businessmen to behave differently without any observable enforcement of the laws.

At the same time, I do not see how a common carrier obligation can be enforced at all in the absence of explicit, detailed rate regulation. In competitive markets, when businessmen negotiate with each other they argue that their competitors are getting better prices from suppliers and that suppliers should give them the same or better prices. But in competitive markets, we don't make Federal cases out of these negotiations and the arguments one firm's purchasing agent makes to another firm's sales agent.

Mr. **Breaux**. I guess if oil pipelines will be using State eminent domain authority to get the routes to build the lines, that they probably would be all faced with a common carrier requirement by the State that granted the eminent domain authority, would they not?

Mr. DeMuth. In most circumstances, I believe that's correct. Yes, sir.

Mr. Breaux. So even with the administration's position to remove the common carrier requirement in a deregulated situation, you would still probably most times, if not all, have oil pipelines which would be common carrier because of State regulations.

Mr. DeMuth. Yes, sir. I think that's true. But I do not know what, as a practical matter, the common carrier obligation means in the absense of a rate regulation. Suppose I go to somebody who is not regulated as to rates, but is a common carrier.

And I say I'd like to use your pipeline. He says well, make me an offer—I'm a common carrier, Which means I have to provide service upon reasonable request, so I have to know what your offer is to decide if your request is "reasonable." I respond that I will pay *x* dollars for this service, and the pipeline says well, in my mind a reasonable request would be 5*x*. I say that's not reasonable at all. I'm going to go to FERC. You're a common carrier.

Now, I say it should be *x* and the pipeline says it should be 5*x*. How, in the absence of rate regulatory powers, is FERC going to decide what is "a reasonable request" and under what terms the pipeline is to be required to provide me access?

Mr. Breaux. Compare his rates that he is charging people who are using it. If he's charging everybody else $10, and he wants to charge you $44, that's not common carrier obligation being fulfilled.

Mr. DeMuth. But other shippers will not be in the identical circumstance—the pipeline's costs of serving them may be lower, so we will argue before FERC over the "true" costs of serving me versus the costs of serving various other shippers, in order for FERC to decide what the rate for serving me should be. And this is rate regulation. In a competitive market it is unnecessary for the Government to superintend private business negotiatious in this way.

Mr. Breaux. I appreciate your comments.

Mr. Anderson. Thank you very much, Mr. DeMuth, for your presentation. We do have to go vote, and so we'll recess at this time for about 15 minutes. We'll return as soon as we can.

[Whereupon, a short recess was taken.]

Mr. Anderson. The meeting of the subcommittee will come to order.

Our next witness is Mr. Jan W. Mares, the Assistant Secretary for Fossil Energy of the Department of Energy; and Mr. Leonard Coburn, Director of the Office of Competition, Department of Energy.

Mr. Mares, I do have your prepared statement. It will be made a matter of the record in its entirety.

[Statement referred to follows:]

STATEMENT OF JAN W. MARES, ASSISTANT SECRETARY FOR FOSSIL ENERGY, U.S. DEPARTMENT OF ENERGY

Mr. Chairman, Members of the Subcommittee, I am Jan W. Mares, Assistant Secretary for Fossil Energy, Department of Energy. I appreciate the opportunity to appear before you today to present the views of the Department of Energy on oil pipeline deregulation. The Department of Energy supports expedited deregulation of the competitive portion of the oil pipeline industry. During this past year we have made substantial progress in formulating a set of principles for the deregulation of oil pipelines. I would like to discuss them with you today.

I. H.R. 2677

You have before you H.R. 2677 for consideration. This bill would deregulate the rates of all oil pipelines quickly and completely. It would maintain the common carrier and antidiscrimination provisions of the Interstate Commerce Act. It would prevent states from regulating in areas that were regulated at the federal level prior to this bill. While we agree with much of the approach taken by H.R. 2677, we cannot support the bill in its present form. There are very fundamental issues that the bill does not address.

The bill does not differentiate among pipelines in its approach to rate deregulation. All pipelines are treated the same. It makes no allowance for maintaining regulation where a pipeline has substantial market power, that is, where a pipeline faces little or no competition from other pipelines or other sources. This is unacceptable to the Department because it fails to address the serious competitive issues inherent in deregulating a pipeline that should remain regulated. One example comes quickly to mind. The Trans Alaska Pipeline System (TAPS) would be deregulated under this bill. We could not support a bill that would deregulate this pipeline because of the substantial market power inherent in TAPS. The owners of TAPS have too great an ability to affect wellhead prices of crude oil on the North Slope, to affect future bidding for leases in the Arctic frontier areas, and to affect competitive relationships not only in Alaska, but in the lower 48 states. There may be other pipelines with substantial market power that should not be deregulated. A deregulation bill must establish some screening device to make sure that deregulation is not detrimental to competition in the oil industry. H.R. 2677 fails to do this. We also are concerned about the excessive breadth of the state preemption provisions.

II. DEREGULATION PHILOSOPHY

The Department of Energy firmly supports deregulation of the oil pipeline industry. But in pursuing deregulation we want to make sure that deregulation does not go too far, thereby harming consumers and competition. We want to make sure that where a pipeline has substantial market power, regulation remains in place to ensure that rates are reasonable. Since in those situations where a pipeline has substantial market power the marketplace has failed to ensure that rates will be reasonable, regulation must remain. Regulation in this situation is the only viable option to protect consumers and to protect the competitive process. In addition, there must be an assessment of the benefits and costs of regulation, so that regulation is relied upon only when both the benefits and costs justify regulation.

III. PRINCIPLES OF DEREGULATION

During this past year we have had the time to formulate a general set of principles for the deregulation of oil pipelines. We have moved some distance from our testimony of last year. All we could say then was that deregulation with some form of reregulation mechanism was the appropriate way to ensure that pipelines did not abuse their market power. We asked the Congress for time to generate more details. During this time we tried to develop various tests for this deregulation approach. All of these tests were so complicated that we abandoned them as well as the entire deregulation/reregulation approach. We have learned much from this effort. We now are working on the premise that most pipelines face sufficient competition and should be deregulated immediately. A few probably never should be deregulated. We are developing a way to screen out the problem few from the competitive many.

I would like to outline for you some of the principles that a pipeline deregulation bill should contain:

1. Deregulation should be as broad and quick as possible.

Deregulation can be accomplished through a rulemaking procedure or some other appropriate form of expedited process to deregulate as much of the industry as quickly as possible. In the rulemaking, the rulemaker will indicate which pipelines will be candidates for deregulation and which pipelines will be candidates for continued regulation. The pipelines which are deregulated through the rulemaking would be deregulated within a very short period of time, for example six months. The remaining pipelines would continue in a more detailed rulemaking proceeding.

Our study of the industry in conjunction with the Department of Justice leads us to believe that most pipelines would be deregulated quickly. Only a small number would remain in the rulemaking; however, they represent a significant portion of the throughput of the industry.

2. Objective criteria are required to screen the pipelines in the rulemaking.

The criteria must use established economic principles concerning market power so that the rulemaker will be able to apply them objectively to all pipelines. They must be established in a way that will not result in most pipelines falling within the determination of market power; otherwise there would be little sense in trying to deregulate the industry.

The criteria should delineate the universe of competitors within which market power is measured. The universe should be broadly defined so that actual and potential competitors are considered.

3. Regulated pipelines could be deregulated in the future. The bill would establish a mechanism where those pipelines still subject to regulation could be deregulated in the future. This would ensure that if circumstances changed the pipeline could be deregulated.

4. TAPS should remain regulated. The bill must exempt TAPS from its effect. It is clear that TAPS has substantial market power and should not be deregulated. Placing it in the rulemaking proceeding would be a waste of resources for all concerned.

5. The antitrust laws apply to deregulated pipelines. The bill must make an explicit recognition that the antitrust laws apply to pipelines that are deregulated.

There still are some unresolved issues, many of which concern details about the conduct of the deregulation proceeding.

Thank you for the opportunity to outline our approach to oil pipeline deregulation to your Subcommittee. I would be glad to answer any questions you may have.

Mr. **ANDERSON**. Please proceed.

TESTIMONY OF JAN W. MARES, ASSISTANT SECRETARY FOR FOSSIL ENERGY, DEPARTMENT OF ENERGY, ACCOMPANIED BY LEONARD COBURN, DIRECTOR, OFFICE OF COMPETITION, DEPARTMENT OF ENERGY

Mr. **MARES**. Thank you, Mr. Chairman.

The Department is very appreciative of the opportunity to appear before you today to present our views on oil pipeline deregulation.

The Department of Energy supports expedited deregulation of the competitive portion of the oil pipeline industry. We do not support, however, the deregulation of TAPS.

During the past year we've made substantial progress in formulating the set of principles with deregulation of oil pipelines. Those principles are included in my testimony.

You have before you H.R. 2677 for consideration. This bill would deregulate the rates of all oil pipelines quickly and completely. While we agree with much of the approach taken by H.R. 2677, we cannot support the bill in its present form for reasons stated in my testimony.

I think in recognition of the time you have left for the hearing today and the other witnesses that you are going to want to question, I would close with the conclusion that we firmly support deregulation of the oil pipeline industry, but in pursuing that deregulation, we want to make sure that deregulation does not go too far, thereby harming consumers and competition.

I would be pleased to answer any questions you may have, Mr. Chairman.

Mr. **ANDERSON**. Mr. Mares, on page 2 of your statement, you state "we are also concerned about the excessive breadth of the State preemption provisions." Would you advocate deregulation of most oil piplines by the Federal Government, and at the same time advocate some regulation of interstate oil pipelines at the State level? And would you please explain your answer?

Mr. MARES. The answer to the first part is the pipelines which are determined to be competitive, should certainly be deregulated from a Federal standpoint.

Regarding State regulation, it has clearly been the view of this administration that States are competent to regulate economic factors within their jurisdiction, and we would continue to support that.

Mr. ANDERSON. So then you could have deregulation on some of these lines at the Federal level, but regulation then at the State level of those same lines?

Mr. MARES. If a State chose to intervene for reasons that it thought were sufficient.

Mr. ANDERSON. How effectively do you think 48 different regulatory schemes would work?

Mr. MARES. I think that the impact of each regulatory scheme would have to depend on the facts and circumstances of the pipeline or pipelines being affected by the particular State.

Mr. ANDERSON. I used to be chairman of the commission in California, we call it the Reciprocity Commission, that tried to work out in lieu fees with the different trucks operating between the different States and how much, for example, a truck registered in Illinois paid to California, assuming it used California roads.

And I found with 48 different States having different regulatory bodies on that kind of a pipeline, it was a maze. And I would think we could have the same thing. I realize there aren't as many pipelines crossing State lines as there are trucks, but one of these maps show crude oil pipelines—it's pretty complex. And this next one here is product pipelines. But if you put them both together you've got a lot of crossing of State lines.

And I would think if one State had one different body, another one different regulations, it's going to be a real problem.

Mr. MARES. The system that you have described has in fact been developed over a long period of time; it has been in place for a long period of time.

Mr. ANDERSON. But there has been Federal regulation having some sort of minimums throughout. And any State regulation would be in addition to the Federal.

You're suggesting to do away with the Federal but have the States take up their own regulation.

Mr. MARES. I think the affected States through which those pipelines are traversing have been aware of them for an extended period of time. They are aware of the possibility that there are issues that need State attention.

And I have confidence that those State regulatory agencies, if there is an issue that needs their attention, will address it in a sensible fashion.

Mr. ANDERSON. But, you see they have at the present time been under the umbrella of a Federal regulatory scheme. According to your remarks, we're suggesting that we do away with that, and to supplement those with each individual State's regulation.

Mr. MARES. We're not suggesting that there is a need for any State to take any regulatory action. What we're saying is that is a decision that ought to be the States, not the Federal Government's.

Mr. ANDERSON. You state on page 4, that objective criteria are required to screen the pipelines and the rule making.

Which agency would you recommend to do the rulemaking proceeding?

Mr. MARES. We have not yet decided which agency to recommend within our own interagency discussion process.

Mr. ANDERSON. What specific economic principles concerning market power should be utilized to determine which pipelines should or should not be deregulated?

Mr. MARES. I think in the course of the testimony already given that there have been several types of criteria that have been enumerated as ones that must be considered. From the standpoint of the Department, we recognize that all those are criteria that should be considered, but have not ourselves enumerated a particular set that we think at this stage ought to be presented as either a final departmental set of criteria, or ultimately, as you're aware from earlier testimony, complete administration set of criteria that we propose be adopted.

That is one of the things that is still being considered in the course of the interagency work in preparation of such a proposal.

Mr. ANDERSON. A little later today, Robert Maynard, the assistant attorney general for the State of Alaska will testify that the ability of TAPS owners to use TAPS to shelter oil income from the windfall profit tax and State severance tax and royalty obligations has been the subject of several Congressional, IRS, and State hearings.

Deregulating TAPS would give near total discretion to the owners to shift revenues away from their tax liable producing affiliates to their pipeline subsidiaries.

Now, do you agree or disagree with that statement? And please explain why you agree or disagree with that statement?

Mr. MARES. I would prefer to answer a different question, which is that the administration does not support the deregulation of TAPS. Thus it's not necessary for me to answer or do the analysis that would allow me to answer that question.

Mr. ANDERSON. So you feel that deregulation of the pipeline industry should have a provision to exclude TAPS from its provisions?

Mr. MARES. That is correct.

Mr. ANDERSON. Mr. Wolf?

Mr. WOLF. No questions, Mr. Chairman.

Mr. ANDERSON. Mr. Breaux?

Mr. BREAUX. TAPS should be out because of no competition?

Mr. MARES. Yes. It's a single pipeline bringing the oil off the North Slope down south, that is south within Alaska.

Mr. BREAUX. Could you make the argument that the marketplace, although it's only one carrier, will dictate what the pricing should be for a single carrier pipeline in the sense that if it prices itself out of the business it's not going to sell any oil and therefore, it's going to be inoperative, because it's not price competitive. Not because they don't have a line that runs along the side of it; because it has to compete with oil from the lower 48 as well as with oil that's being imported from around the world.

Mr. **Mares**. There was a dialog regarding that issue earlier wherein Mr. DeMuth indicated, and I agree with him, that there are circumstances where a single pipeline does have competitive pressures on it from other means of transportation or availability of product, whether it's from oil fields or refining. Under those circumstances, such a pipeline would not be in a competitive situation.

The analysis that we have done, and our judgment is that TAPS does not meet those criteria, and that it should continue to be regulated.

Mr. **Breaux**. Does not the price that TAPS charge have to be competitive with prices charged by oil from the lower 48?

Mr. **Mares**. The price of North Slope oil as it finally reaches the market has to be competitive with the alternative supplies of oil. But that price, when it finally meets the market, is a combination of wellhead as well as transportation costs.

Mr. **Breaux**. Yes, but particularly with TAPS, isn't the price of the transportation far greater than in any other operation?

Mr. **Mares**. To the best of my knowledge, it is a very high portion of the final price, certainly well above the average transportation cost.

Mr. **Breaux**. I'm just trying to find out the distinction—apparently, they've already made a decision that TAPS should be continued to be regulated, although previous administration spokesmen have said that they could conceive of a situation where one carrier, one pipeline, would still not constitute a monopolistic practice.

I'm trying to decide the difference on the thing. It seems like I can point to a lot of instances where there is competition pressure on TAPS which would regulate how much it's going to charge. Otherwise, it wouldn't be in business.

I'm trying to find out what's the difference. Why with TAPS, which is subject to competition from other sources of energy?

Mr. **Mares**. I think both in Mr. Baxter's and in Mr. DeMuth's testimony there were specific reasons given as to why TAPS should continue to be regulated. I believe those were responsive to your question.

And I would agree with their views on that.

Mr. **Breaux**. I'm not sure I got the difference there either. What's your position for DOE with regard to common carrier status and discrimination, antidiscrimination?

Mr. **Mares**. If you conclude that a particular pipeline is in a sufficiently competitive market, then it does not need rate regulation. Under such conditions, it's hard for me to see why it needs rate or access regulations.

So that the answer is we would not recommend that those two forms——

Mr. **Breaux**. Assume for the sake of argument that we say that a pipeline does not have to be a common carrier. And assume the hypothetical case of a major oil company shipping, that owns a pipeline, is shipping its own product through it.

Would it be legal under that type of arrangement for them to arbitrarily discriminate against others using that pipeline, so that their product owned by their subsidiary can use it?

Mr. **Mares**. My experience with the competitive market would indicate that if you are in a competitive market, which is the only market for which we're suggesting deregulation, the pressures on a firm, even with its interrelated activities are such that—as well as the antitrust laws which still are applicable to these situations—the firm will respond in a market oriented fashion. You will not have the type of economic discrimination that you're describing.

Mr. **Breaux**. Well, the market competition may be that I want to squeeze out the XYZ refinery and the small independent producer because I don't want him to get his oil to the small refinery, because I want my refinery to get it, and my retail outlets to sell it. Therefore, I am going to exclude you, period.

And the law says I can do that because I'm not a common carrier.

Mr. **Mares**. The antitrust laws are not being repealed as it relates to the pipeline carriers.

Mr. **Breaux**. So the only thing that would be available, though, is for him to go through the antitrust laws?

Mr. **Mares**. The antitrust laws have an enormous impact on the behavior of firms.

Mr. **Breaux**. What's wrong just by adding the fact that they are a common carrier? Is that just a philosophical hang up, or is there a real reason for doing away with it?

Mr. **Mares**. If you start with the proposition that the market is competitive, then it does appear to us inconsistent to add a series of regulatory constraints.

Mr. **Breaux**. I just see a lot of potential for abuse if you end up with someone who wants to abuse it, and what you're saying is that antitrust laws, you would have to go that route.

I mean, what's wrong with just saying that you're a common carrier? I don't understand why that causes the administration a problem other than maybe just a philosophical problem saying that if you're going to deregulate pricing you ought to deregulate common carrier status.

What problems would it create to say that you are a common carrier in this legislation? Why is that phrase out? Why should it be out? What's wrong with it? What problems does it cause by remaining in there?

Mr. **Mares**. I'll say it again. I think if you're starting with the proposition that the market is competitive as it relates to the particular pipeline, and you start with the proposition that a competitive market will make the most efficient economic choices for the consumer on the long term basis, then, I think you're logically taken to the posture that you should try not to fetter that market.

Mr. **Breaux**. OK. What you're saying, though, is that you're making a number of assumptions that I'm not sure I agree with necessarily, and you're saying that if those assumptions are true, common carrier status might not be needed.

Well, my point is if we do include it, why is it bad? What's wrong with it? You are saying it's not needed. But I'm saying if we have it in there, and make the decision to have it in there, what problems, if any, does that cause? I don't see any problems a common carrier declaration would cause to justify us taking it out.

Your argument is that assuming this and assuming that the competition is going to take care of that. But make another assumption, that we do have it in, what problems, if any, would that cause?

Mr. **Mares**. The anxiety that I would have is that it creates an additional type of constraint that has to be considered by the firms that might be subject to it. We're dealing with a situation where we've decided that deregulation is appropriate for the particular pipeline.

So what we would be saying in your example is, let's deregulate him but not very much. And yet we have already decided that it is desirable to deregulate them because there is a competitive situation.

Mr. **Breaux**. You're saying it could possibly be a disincentive?

Mr. **Mares**. What you're saying adds an economic regulatory burden which is not justified by the predicate which took you to the stage of wanting to deregulate them in the first place.

Mr. **Breaux**. How is it an economic disincentive if you can charge the same price to all of them, they'd have to pay it or they couldn't use it?

Mr. **Mares**. You're——

Mr. **Breaux**. Common carrier status wouldn't require you to charge less or be a disincentive on your return of investment. You could charge whoever is using it at the same price.

Mr. **Mares**. We are trying to identify pipelines which are sufficiently competitive that they can be free of regulation, not to institute different or additive regulation. And it seemed to me that if you reached the conclusion that it is sufficiently competitive not to warrant the regulation, then to add something back that is not required from the competitive standpoint starts you back down the road that you're trying to get away from, namely regulation on pipelines which are in fact competitive.

Mr. **Breaux**. I'm just not sure I'm hearing any reason as to why it would cause problems. I know philosophically you're saying if you're going to deregulate it because of competition, you don't need this.

I'm not sure I see a reason, or a problem that it does create in having it there. There's a potential for abuse that exists out there with regard to vertically integrated companies versus small or independent operators, both refiners and independent producers who could be frozen out without the common carrier status of access to a way of shipping their product.

Mr. **Mares**. That is an assertion.

Mr. **Breaux**. It's a possibility.

Mr. **Mares**. Yes, but I have to go back and say again that if we're only addressing those pipelines that are competitive, I don't think that the possibility is sufficient to warrant adding regulatory measures to the legislative approach to competitive pipelines.

I acknowledge that this is an area on which reasonable people can differ. But that's the position——

Mr. **Breaux**. Well, we can both agree we're both reasonable.

Mr. **Mares**. I'll stipulate to that as well.

Mr. **Breaux**. Thank you very much. Thank you, Mr. Chairman.

Mr. **Anderson**. Thank you very much, Mr. Mares, and Mr. Coburn for your presentation.

Next is a panel of two—Mr. Robert Maynard, assistant attorney general from the State of Alaska, and Mr. Mark Wittow, associate director for Natural Resources and Transportation, Governor's Office, State of Alaska.

Before hearing from the panel, I would like to place in the record, at this point, the statement received from Senator Frank Murkowski from the State of Alaska.

[Statement referred to follows:]

Statement of Senator Frank H. Murkowski

The issue of petroleum pipeline regulation merits the attention of Congress, and I would like to commend Representative Breaux for his leadership in proposing deregulation legislation. Generally, I am an advocate of deregulation initiatives, and I believe the deregulation of most petroleum pipelines in the United States is in the public interest.

As every member of this Committee knows, the largest and most unique pipeline system in the nation lies in my own State of Alaska. The Trans-Alaska Pipeline System (TAPS) represents about half of the total investment in U.S. petroleum pipelines, and it provides roughly half of the revenues of all major U.S. petroleum pipelines. While petroleum pipeline tariffs in the lower-48 average 30 to 40 cents per barrel, TAPS tariffs average between $6 and $7. TAPS clearly isn't "just another pipeline."

I cannot support H.R. 2677 in its current form because it would result in the deregulation of the Trans-Alaskan Pipeline System. The deregulation of petroleum pipelines will serve the public interest when competitive alternatives exist; it can only serve the pipeline owners' interest when competitive alternatives do not exist. Such is the case with TAPS.

There are no competitive alternatives to TAPS. TAPS is the only possible means by which Alaska North Slope oil—almost 20 percent of our domestic production—can reach its markets in the lower-48. TAPS is a monopoly. It has no actual or potential competition. Alternatives such as ice-breaking tankers, a trans-Canadian pipeline, and railway transport have been promptly rejected in the past as impractical. The physical, legal and economic difficulties associated with the construction of another competing alternative, particularly when the capacity of the existing TAPS can be expanded at a fraction of the cost of new pipeline construction, makes the construction of a competing alternative a remote possibility.

You will probably hear it said during the course of these hearings that TAPS is actually eight pipelines in function, if not in form, and that competition will result from the competition between the eight owners. The fact is, the prospect of competition among TAPS owners is unlikely so long as the pipeline remains at or near capacity and affiliates of the major owners of the pipeline are also the major North Slope producers.

North Slope oil producers, through their affiliates' ownership of TAPS, control the major portion of the sole means of getting their oil to Valdez. As a result, a rational TAPS owner who is free to set his own tariff will not be inclined to lower his rates. Alaskan North Slope producers pay State and Federal taxes based on the "wellhead value" of the oil, the wellhead value being the market price less transportation costs. As I understand it, higher transportation costs, most notably higher TAPS tariffs, generally result in lower wellhead taxes for North Slope producers and higher profits for their pipeline affiliates—the best of both worlds. As a consequence, the pipeline owners in an unregulated situation will have an economic incentive to set their tariffs at the maximum level possible.

In a very real sense, Mr. Chairman, the pipeline owners have already given us a preview of the behavior that would guide their tariff determination were TAPS to be deregulated. There is good reason to believe that the TAPS owners are currently charging excessively high tariffs which are resulting in excessively high rates of return. As a result of inquiries by your Colleagues in the House Small Business Oversight Subcommittee, the Federal Energy Regulatory Commission has issued a report estimating the rates of return enjoyed by TAPS owners. Exxon, for instance, claims that it earned a 15.68 percent rate of return on its TAPS investment in 1981. The FERC estimates that Exxon's 1981 rate of return was 36.86 percent, and the

State of Alaska estimates Exxon received a 43.78 percent return on its investment. The numbers are similar for another TAPS owner, ARCO, which claimed a 16.67 percent rate of return in 1981. FERC's estimate is 36.66 percent, while the State of Alaska puts the figure at 45 percent.

Mr. Chairman, I have to question the wisdom of deregulating a monopoly pipeline whose owners are enjoying up to a 45 percent rate of return in a regulated environment. Make no mistake about it—the current regulatory framework has been unable to restrain these high rates of return, and the ponderous proceedings at FERC have failed, even after six years, to arrive at a methodology that will result in a just and reasonable TAPS tariff. However, the failure of the regulatory process must not, in the case of TAPS, force us to discard that process altogether. The unique nature of TAPS requires a different, more creative solution.

Perhaps, for instance, we will have to legislate an end to the TAPS tariff dispute which will result in a just and reasonable rate of return without the expense and bother associated with continuing the ponderous rate case. That may be an answer. TAPS deregulation, on the other hand, is 180 degrees in the wrong direction. I urge the Committee to modify H.R. 2677 to exclude TAPS from rate deregulation.

Thank you, Mr. Chairman.

Mr. ANDERSON. We will now hear from Mr. Maynard and Mr. Wittow.

I have a position paper of the State of Alaska on H.R. 2677. It's not identified which one of you. Is that yours, Mr. Maynard?

Mr. MAYNARD. It's mine, Mr. Chariman.

Mr. ANDERSON. And I also have a letter signed by Norman Gorsuch, Attorney General of the State of Alaska. Is that also yours, Mr. Maynard?

Mr. MAYNARD. Yes, it is, Mr. Chairman.

Mr. ANDERSON. Well, then both of these will be made a matter of the record at this point.

[Items referred to follow:]

POSITION PAPER OF
THE STATE OF ALASKA
ON HR 2677 AND DEREGULATION OF
TRANS ALASKA PIPELINE SYSTEM

November 9, 1983

The State of Alaska appreciates this opportunity to state for the record its views on the question of oil pipeline regulation, an issue in which the State has long had a direct and vital interest.

The State's comments will deal only with regulation of the Trans-Alaska Pipeline System -- TAPS, as it is known -- and its feeder lines. Alaska takes no position on the question of pipeline deregulation in the Lower 48 states, but believes that whatever Congress may conclude about the desirability of continuing or discontinuing oil pipeline rate regulation as a general matter, such regulation should without question be continued for TAPS.

Why should Congress single out TAPS? The short answer is that its size and monopoly status lead to consequences that are dramatically adverse to the public interest and welfare, including, for example, a counter-incentive to our search for energy independence. Some of these consequences have been demonstrated in testimony recently filed at the FERC by the State. In that testimony, the State's witnesses, led by Dr. Alfred Kahn, former Chairman of the Civil Aeronautics Board and a distinguished regulatory economist, demonstrate that unless TAPS is regulated under the standard rate-setting approach applied to electric and gas utilities:

-- approximately a billion barrels of recoverable Alaskan crude oil will not be produced, because of high pipeline rates;

-- consumers nationwide will pay an extra billion dollars a year in gasoline and other energy costs;

-- the federal treasury will lose some $15 billion in tax and royalty revenues; and

-- the State will also be deprived of nearly $10 billion in lost tax and royalty revenues.

* * * * *

As the owners of TAPS have now virtually conceded, TAPS is and will remain a natural monopoly. In the absence of regulation its tariffs will remain unreasonably high. Because the price sellers receive for North Slope oil is the price at market less transportation charges, high transportation charges undermine the incentives for development of the North Slope of Alaska, our most promising source of new oil discoveries. High charges for transportation reduce the wellhead price, lowering the "expected value" of each project and thus the number of projects developed and the amount of oil produced from those projects that are developed. High tariffs therefore undermine the nation's (and Alaska's) critical interest in development of the promising oil and gas potential in and near Alaska's North Slope. By discouraging exploration, development and production -- particularly by oil companies that are not owners of TAPS -- high TAPS tariffs may well deprive the nation of hundreds of millions of barrels of domestic oil, forcing us to rely on insecure foreign sources and worsening our balance of payments.

High tariffs also deprive Alaska and the United States of hundreds of millions of dollars of tax and royalty revenues each year by allowing TAPS' owners to use TAPS as a tax shelter to avoid federal windfall profits tax, state severance taxes and state and federal royalty obligations. For reasons explained later in this statement, each dollar increase in TAPS revenues decreases federal revenues by between 10 and 15 cents, and reduces Alaska's revenue from royalties and severance taxes by approximately 25 cents.

TAPS' size alone justifies special attention from the Congress. TAPS and its feeder lines comprise the single largest oil pipeline system in the country. In fact, TAPS represents approximately half of the total U.S. investment in oil pipelines -- more than 9 billion dollars -- and earns approximately half of the revenues of all major U.S. oil pipelines. Moreover, it is the only means of transporting oil from Alaska's North Slope to U.S. markets. It is not merely another pipeline, and Congress can and should take specific account of TAPS' unique status as it considers pipeline regulatory policy.

In addition, TAPS has a combination of special characteristics that would make deregulation of its rate-setting processes very bad public policy. The historical basis for regulation of oil pipelines as utilities has direct applicability to TAPS, and the arguments advanced for deregulating pipelines in the Lower 48 states are inapplicable to it. Congress need not take the word of the State of Alaska on this point. In previous testimony on the subject, the Departments of Justice and Energy, the Federal Energy Regulatory Commission (FERC), and the Office of Management and Budget all agreed that TAPS should remain regulated even if pipelines in the lower 48 states are not.

Rate regulation was imposed on oil pipelines in 1906 because of a perception that those pipelines had substantial monopoly power which could be -- and had been -- used to achieve anticompetitive and other undesirable economic ends. Most directly, such monopoly power was seen as permitting pipeline owners to raise tariffs above competitive levels. Many current advocates of deregulation believe that oil pipelines no longer possess such monopoly power as a general matter, and that workable competition among pipelines or with competing modes of transportation may operate to keep pipeline rates at or near competitive levels in the absence of regulation. The FERC appears to have accepted this view for lower 48 pipelines in its November 1982 Williams opinion, which is now on appeal. The FERC did not accept this view for TAPS, however. Recognizing that TAPS is special, at the same time as it released its Williams opinion, it sent the TAPS rate case back to a law judge for views on whether the methodology endorsed in Williams should be applied to TAPS' special situation.

Congress, too, has recognized the unique status of TAPS by passing a special Act of Congress to enable the pipeline to be built.

Without getting into the debate over whether competition works to keep pipeline rates down in the lower 48, Alaska wants to emphasize that it is clearly not true as far as TAPS is concerned.

TAPS is a natural monopoly, insulated from actual or potential competition. There is no network of competing pipelines or alternative modes of transportation to which deregulation advocates can point as forces tending to keep rates down. TAPS is the only pipeline between Prudhoe Bay and Alaska's southern coast, and will doubtless remain so. It cost $9 billion to construct in the mid-1970's, and, given the physical, financial, legal, and economic difficulties involved, it is clear that no competing pipeline will be built. If the need for additional capacity ever arose, it would be far cheaper to expand TAPS than to duplicate it.

The Administrative Law Judge in the TAPS rate case now pending before the Federal Energy Regulatory Commission determined, after hearings that fill 25,000 pages of transcript and generated 900 exhibits, that the possibility that another pipeline could be built to compete with TAPS is "remote." There is, Judge Kane found, "no substantial risk today of that possibility."[1] The difficulties experienced with attempts to finance the proposed Alaska Natural Gas Pipeline System merely reinforce that conclusion.

---

[1] Initial Decision Phase I Issues at 84, Trans Alaska Pipeline System, Docket No. OR78-1 (F.E.R.C. Feb. 1, 1980) ("Initial Decision").

Nor is there any existing or potential competition from alternative modes of transporting North Slope oil to U.S. markets. As Judge Kane's opinion in Phase I of the TAPS case pointed out, during the period between the discovery of oil on the North Slope and the commitment to build TAPS, a number of other proposals were considered for the transport of North Slope oil. These included a possible Trans-Canada pipeline route, ice-breaking tankers, trucks, and railroads. All were "promptly rejected" because none was "as economical or generally as feasible" as TAPS.[2] Recent confirmation of the infeasibility of nonpipeline competition with TAPS may be found in the case of the Coast Guard Icebreaker Polar Sea: two winters ago it became ice-bound in the vicinity of Kotzebue, off Alaska's northwestern coast, and could not be extricated until the Spring.

Thus, TAPS as a whole faces neither existing nor potential competition. In the words of Judge Kane, TAPS "enjoys a de facto if not a de jure monopoly position which, for economic feasibility reasons, it is practically certain to retain."[3] No one seriously contests this. The Department of Energy reached the same conclusion in its May 1982 report on "Petroleum Pipeline Deregulation: A Competitive Analysis." Indeed, the owners of TAPS have recently conceded the absence of outside competition. A few months ago, when asked to state their position on the existence of competition in the Phase I remand of the TAPS rate case, the owners responded that they "are not aware of any current efforts to establish a competing transportation system ..."[4]

Nor do the owners of TAPS compete among themselves. North Slope production currently is matched to the capacity of the pipeline, and is expected to match it for many years. While production in the original field of Alaska's North Slope (Sadlerochit) may begin to decline late in this decade, crude oil from other fields will be flowing into the pipeline -- oil from the Kuparuk field, for example, began to flow late in 1981. One U.S. Geological Survey Report states that there is a 95% chance that an additional 7 billion barrels of oil will be discovered on or near the North Slope; if so, all of it will be shipped through TAPS.

---

[2] Id.

[3] Id.

[4] Protestants' and Respondents' Prehearing Stipulation at 12, Trans Alaska Pipeline System, Docket Nos. OR78-1-014, and OR78-1-016 (Phase I) (July 8, 1983).

As long as the pipeline is operating at capacity, there is simply no incentive for any TAPS owner to cut its price or otherwise to compete, since it could not thereby increase its sales. A price cut would merely mean less revenue for the price-cutter. Even if production were to fall below the pipeline's capacity at some point in the future, it is less likely that price competition would ensue than that the pipeline owners would reduce capacity by decommissioning one or more pump stations, much as they have increased capacity in the past by adding pump stations.

The Department of Justice, in briefs filed in the TAPS case, has concurred in Alaska's position that the structure of TAPS' ownership and various other factors make meaningful competition unlikely, even were production to fall below the pipeline's capacity. But the point is academic. The fact is that the pipeline will be operating at capacity well into the foreseeable future, so that at least for a considerable period of time there will be no competition at all among TAPS owners.

The industry-sponsored Mitchell Report on oil pipeline deregulation does not address TAPS, and the TAPS owners therefore commissioned Richard J. Barber Associates, Inc. to prepare a separate report on "The Transportation of Alaskan North Slope Oil By Pipeline." The Barber Report, which was released in May of 1982, argues that continued regulation is unnecessary to keep TAPS rates reasonable because of existing competition among the owners of TAPS, potential competition from other means of transporting North Slope oil to market, and the alleged long-term interest of the owners in reasonable rates as a means of encouraging the development of North Slope reserves and thus keeping TAPS full. The State believes that the Barber Report is deeply flawed and wholly unpersuasive.

First, the Report cites the fact that the published tariffs of the TAPS owners differ as evidence of competitive forces. But some owners have acknowledged, and as to others it has been shown in the TAPS litigation, that TAPS tariffs were set at the maximum allowed by a 40-year-old consent (since vacated) decree that restricted oil pipeline dividends and thus effectively limited rates. TAPS rates have varied only because the owners have had differing debt/equity structures and therefore different limits under the consent decree. Moreover, as a consequence of cross-tendering much of the oil that moves through the pipeline does so at the composite rate -- now about $6.20 per barrel.

In short, there is no price competition within TAPS. If there were, all of the TAPS owners would have reacted when Exxon reduced its rates from $6.30 per barrel to $5.30 per barrel in December 1982 to meet the requirements of the consent decree. For six months, however, none of them did anything, and their respective shares of TAPS-transported oil did not change. In July, 1982, British Petroleum reduced its rates, but did not claim that competitive forces played a role in its decision. And as soon as the consent decree was vacated, both Exxon and BP moved to raise their rates to the prior levels, again with no effect on their respective market shares.

Second, the Barber Report cites potential competition from surface tankers and other, as yet unbuilt, pipelines as a constraint on TAPS rates. As noted earlier, however, this is simply unrealistic. The State would have thought that the conclusions of Judge Kane and the Department of Energy, the difficulties facing the Alaska Natural Gas Transportation System, and the fate of the icebreaker Polar Sea would lay to rest all speculation about alternatives to TAPS, including a stream of tankers moving in the Beaufort and Chukchi Seas.

Third, the Barber Report dwells at length upon the competitive nature of the market for Alaskan Oil on the West and Gulf Coasts of the United States, but does not discuss why that fact has any bearing on TAPS rates. As the Report acknowledges, by the forces of supply and demand, a $1 increase in TAPS rates would not raise the price of Alaskan oil by $1; it would instead reduce by $1 the wellhead price of the oil at Prudhoe Bay, which is determined by subtracting shipping costs (including TAPS tariffs) from the market price. Market prices for crude oil thus would restrain TAPS tariffs only if the TAPS owners were interested in maintaining the wellhead price and were willing to limit TAPS tariffs in order to do so.

The centerpiece of the Report is in fact the argument that in order to spur exploration and development of North Slope reserves so that enough crude oil is produced to fill the pipeline, the TAPS owners are interested in encouraging a reasonably high wellhead price, and that this interest restrains TAPS tariffs. The State is pleased at the TAPS owners' acknowledgment that the wellhead price of North Slope oil has an effect on exploration and development. Because the Barber Report completely ignores the fact that the TAPS owners are also oil producers, however, its conclusion that the relationship between wellhead prices and North Slope development restrains TAPS tariffs is simply wrong.

To a producer who is also a pipeline owner, revenues from production and shipment are simply two parts of a single stream of income from Alaskan oil. All other things being equal, an integrated company would thus be largely indifferent between a dollar of wellhead revenue and a dollar of shipping revenue. But all other things are not equal. For one thing, as explained below, recent changes in the Internal Revenue Code have caused TAPS income to be taxed at lower rates than income from the sale of Sadlerochit oil. In addition, while TAPS faces no competition in the shipment of North Slope oil, there is considerable competition for the right to explore and develop North Slope reserves, which manifests itself in bidding for oil leases on State, Federal, and Alaska Native lands. The lower the projected wellhead price, the lower the bids. To an integrated company, therefore, the "correct" strategy is obvious -- maximize the TAPS tariff and so minimize wellhead price. The total stream of gross revenues will be the same to the integrated company, whatever it does. But if the wellhead price is kept low there will be lower taxes, less competition and lower bids for leases, and thus higher net revenues in both the short run and long run.

The ability of TAPS owners to use TAPS to "shelter" oil income from the windfall profits tax and state severance tax and royalty obligations has been the subject of several Congressional, IRS and state hearings. Deregulating TAPS would give near total discretion to the owners to shift revenues away from their tax-liable producing affiliates to their pipeline subsidiaries.

In sum, neither alleged but unproven competition nor unsupported assertions about the long-term interests of the TAPS owners can be counted upon to keep the rates of an unregulated TAPS at reasonable levels. We must assume that rates would remain, if otherwise unconstrained, more or less at monopoly levels. This, of course, operates to the detriment of non-owner shippers. If it is in the national interest to have more independent oil companies bidding on and developing North Slope lands, and we believe it is, these companies should not be discouraged from these endeavors by high TAPS tariffs. Monopoly level tariffs also injure the State of Alaska by increasing the portion of the market price of crude oil attributable to transportation and decreasing the remaining portion -- that is, the wellhead price -- on which the State's royalty and tax revenues depend.

But that is not all. Excessive TAPS rates also decrease the income of the United States by reducing revenues from lease sales on the North Slope and federal corporate income tax receipts. The Tax Equity and Fiscal Responsibility Act of 1982, passed by Congress last year, eliminated the *de facto* windfall profits tax exemption previously enjoyed by companies shipping oil through TAPS. As a result, profits on the production and sale of Sadlerochit crude are taxed at a maximum rate of 70%, compared to a maximum rate of 46% on pipeline profits. Under the new law, a reduction of one dollar in the TAPS tariff would thus increase Federal tax revenues by between 10 and 15 cents -- over $60 million per year at present production levels.

The issue is not primarily the health of the state and federal treasuries. Of far greater importance is the sensitivity of North Slope production and development to changes in wellhead price, as evidenced by the recent cutback in development of the Kuparuk Field because of reductions in projected oil prices. There are many potential oil producing areas on the North Slope, and development of each of them depends upon an adequate wellhead price. Higher tariffs, with corresponding lower wellhead prices, make production at marginal fields uneconomic. Unlike lower 48 fields, consumer prices do not have to be raised to make additional North Slope oil production economic -- a reasonable TAPS tariff will do the job. But in the absence of competition, TAPS tariffs will not be reasonable unless regulation is continued.

It is also important to the interests of the United States that high TAPS rates significantly misallocate resources and limit competition in the production of crude oil. As the Department of Justice has recognized in the TAPS case, if TAPS rates exceed reasonable levels so that the wellhead price of North Slope crude oil is artificially deflated, incentives for exploration and production of new Alaskan crude oil will be reduced accordingly. Even if the monopoly profits reaped by the TAPS owners are viewed as available for exploration and production, those companies receive a significant competitive advantage over their rivals in the industry who do not own a piece of TAPS, and competition in exploration and production is restricted. Either way, an important part of our national energy policy is undermined to the detriment of the public interest.

It is occasionally argued that the time and resources consumed by the regulatory process outweigh any possible benefits. The process has certainly been lengthy and expensive in the TAPS rate case, but that is attributable in part to the fact that FERC is addressing issues that have never before been properly resolved. It can also be explained, unfortunately, by FERC's failure to resolve the TAPS and Williams cases in a timely manner. The Williams case had been pending before FERC for over a decade when, at the order of a Federal judge, the Commission finally rendered its decision in November, 1982.[5] That decision is now on appeal. By the time Williams was decided, briefing on Phase I of TAPS case had been completed for over two years with no decision from FERC. Rather than deciding TAPS and Williams at the same time, the Commission sent the TAPS case back to the law judge for additional hearings on the impact of the

---

5/ Williams Pipe Line Company, 21 FERC (CCH) ¶61,260 (November 30, 1982).

Williams decision on TAPS.[6] The hearing in that remand proceeding is now scheduled to begin on January 16, 1984.

Once the TAPS and Williams cases are finally resolved and a set of ratemaking principles is established, such proceedings will be much shorter and far less expensive. And, the costs of this litigation must be put into perspective. The total expended by all parties on the TAPS litigation to date has not exceeded the dollars taken in by TAPS in ten days, and the costs imposed on non-owner shippers by the monopoly prices that would prevail in the absence of regulation dwarf the costs of the TAPS case.

To Alaska the issue is straightforward and uncomplicated. The rationale for rate regulation applies directly to TAPS, and the arguments advanced for deregulating other pipelines are inapplicable to this admitted monopoly. Deregulating TAPS would only result in monopoly profits for the pipeline owners while undermining the incentive for competitive development of the nation's most promising energy reserves. There is no reason to include TAPS and its feeder lines in oil pipeline deregulation legislation and every reason to exclude them.

6/ Trans Alaska Pipeline System, 21 FERC (CCH) ¶61,092 (November 30, 1982).

BILL SHEFFIELD
GOVERNOR

STATE OF ALASKA
OFFICE OF THE GOVERNOR
WASHINGTON, D.C.

November 7, 1983

Glenn Anderson
Chairman
Surface Transportation Subcommittee
House Committee on Public Works
  and Transportation
2165 Rayburn House Office Building
Washington, D.C. 20515

RE: H.R.2677

Dear Chairman Anderson:

I enclose the prepared testimony of the State of Alaska with respect to the issue of deregulation of the Trans Alaska Pipeline System ("TAPS"). The State is strongly opposed to the deregulation of TAPS for it believes that deregulation of TAPS would be dramatically adverse to national and State interests.

The State has long been concerned about TAPS, the only route from, and a major key to, development of North Slope oil reserves. Whatever may be argued about the existence of competition with lower 48 pipelines, it is indisputable that TAPS has no competition and will face none in the foreseeable future. That status was confirmed by a FERC Administrative Law Judge who reached that conclusion after twenty-five thousand pages of testimony and exhibits. Recently, in another round of TAPS proceedings at the FERC, the TAPS owners have declined even to offer any evidence on the issue of competition with (or within) TAPS. Without the presence of competition or any potential for it, TAPS rates will remain high above competitive levels. State studies show that today the TAPS owners are charging rates -- about $6 a barrel -- twice as high as traditional utility type regulation would permit.

The State does not rest its case soley on the fact that TAPS is a monopoly. TAPS controls access to the nation's most promising source of future domestic oil. Deregulation would permit TAPS owners to charge high rates. High TAPS rates--for example, at the level permitted by the FERC's Williams methodology--could result, over the next thirty years, in a loss of approximately a billion barrels of future northern Alaska production and the loss of fifteen billion dollars to the federal treasury in tax and royalty revenues, as well as a corresponding State loss of nearly ten billion dollars. In addition, consumers of gasoline and other petroleum products could have to pay an extra billion dollars a year as a result of excessive tariffs.

It has also become clear to us, as the testimony recently filed in the TAPS proceeding at the FERC shows, that the pipeline can be a gigantic tax shelter for companies which both own the pipeline and are heavily involved in production on the North Slope. They are able to transfer income from their production arms to their transportation arms, thereby sheltering it from the federal windfall profits tax as well as from State royalty and tax obligations. Further, the recent evidence shows that TAPS gives its largest owners a competitive edge in bidding on future North Slope and Beaufort sea oil and gas lease sales. Because those owners face less than the nominal price of the tariff, they can afford to outbid other oil companies seeking leases on the North Slope or adjacent offshore areas. Present development of the North Slope is concentrated in a few companies; deregulation of TAPS would give these companies a perpetual advantage.

Because of these consequences, the State of Alaska and the Arctic Slope Regional Corporation have been joined for six years by the United States Department of Justice through its Antitrust Division in seeking that TAPS be regulated in the way all other utilities are regulated--a form of original-cost regulation. For these same reasons, as further explained in the attached statement, the State of Alaska is unalterably opposed to the deregulation of the Trans Alaska Pipeline System.

Thank you for your consideration of our views. If we can provide any further information, please contact me or John Katz of the State's Washington, D.C. office.

Respectfully submitted,

Norman C. Gorsuch /by NW

Norman C. Gorsuch
Attorney General
State of Alaska

Enclosure

cc: Subcommittee Members

5/83

ESTIMATED TOTAL TAPS THROUGHPUT*
(thousand of barrels per day)

	LOW	MOST LIKELY	HIGH
1983	1620	1620	1620
1984	1640	1660	1660
1985	1660	1690	1720
1986	1570	1790	1840
1987	1300	1860	1895
1988	1100	1760	1880
1989	1115	1655	1827
1990	960	1555	1680
1991	835	1470	1565
1992	765	1360	1675
1993	695	1190	1715
1994	605	1115	1760
1995	570	1100	1920
1996	505	1000	2040
1997	440	925	2180
1998	390	860	2050
1999	340	800	1865
2000	225	770	1700
2001	160	740	1535
2002	145	720	1325
2003	135	655	1185
2004	80	610	1075
2005	75	560	985
2006	70	525	905
2007	50	425	810
2008	50	380	685
2009	50	260	540
2010	50	225	405

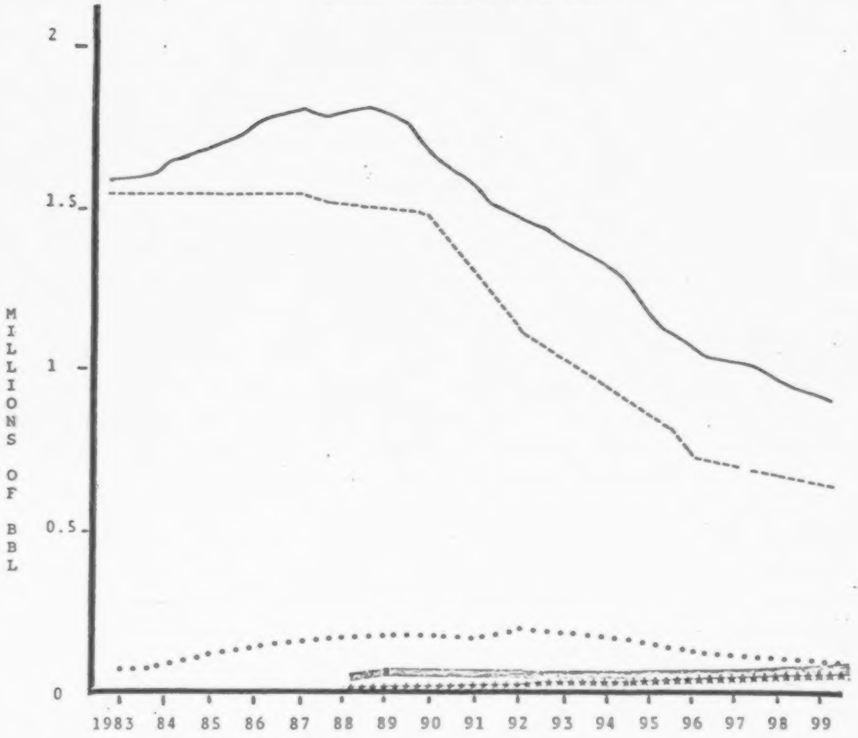
*The total low, most likely and high estimates are simple arithmetic combinations of the respective low, most likely and high estimates from the individual reservoirs. This type of totaling by simple arithmetic combination is not statistically correct and is done here only for order-of-magnitude illustrative purposes.

2598Z

by DMEM
[illegible] Van Dyke

EXPECTED NORTH SLOPE OIL PRODUCTION

11/14/83



LEGEND

------ Prudhoe Bay
• • • • Kuparuk,Milne Point
▭▭▭ Pt. Thompson, Flaxman Island
***** Beaufort Sea
—— Total North Slope Production

Source: Petroleum Production Revenue Forecast (Quarterly Report), Alaska Department of Revenue, March, 1983, p.9.

Note: For more information, contact the Division of Strategic Planning (Office of Management and Budget).

Mr. ANDERSON. Please proceed.

TESTIMONY OF ROPERT MAYNARD, ASSISTANT ATTORNEY GENERAL, STATE OF ALASKA, ACCOMPANIED BY MARK WITTOW, ASSOCIATE DIRECTOR FOR NATURAL RESOURCES AND TRANSPORTATION, GOVERNOR'S OFFICE, STATE OF ALASKA

Mr. MAYNARD. My name is Robert Maynard. I'm an Assistant Attorney General with the State of Alaska, responsible for oil and gas matters for the State.

With me today is Mr. Mark Wittow, Associate Director with the Office of the Governor, here in Washington, D.C.

The State appreciates the opportunity to present its views concerning oil pipeline regulation, an issue in which the State has a specific, direct and vital interest. My comments today will deal only with the regulation of the Trans-Alaska Pipeline System, or TAPS, and its feeder lines.

The State takes no position on whether oil pipeline regulation should continue in the lower 48, because the State feels that no matter what the outcome of that particular debate may be, regulation should without question be continued for TAPS.

TAPS is in practice a monopoly pipeline, and it is the only possible transportation system into the most sensitive and largest oil producing area in the United States.

Eighteen percent of present domestic production, and one third of all potential domestic oil reserves lie in the area exclusively served by the Trans-Alaska Pipeline System.

The evidence shows that unless TAPS is continued to be regulated under the standard rate setting approach applied to electric and gas utilities: First, approximately 1 billion barrels of Alaska crude oil will not be produced; second, consumers nationwide will pay approximately an extra billion dollars a year in gasoline and other energy costs; third, the Federal Treasury will lose some $15 billion in tax and royalty revenues; and fourth, the State will also be deprived of nearly $10 billion in lost tax and royalty revenues.

The underlying reason for these effects is that TAPS is a monopoly; there is no actual or potential competition with the Trans-Alaska Pipeline System as a whole, or among the owners of the TAPS system itself.

The fact of no potential or actual competition with TAPS has been found to be the case by an administrative law judge, by the Department of Energy, and even the companies admit that they know of no current effort to establish a competing system with the Trans-Alaska Pipeline System.

And, since production will always match capacity of the pipeline system itself, there is no competition among the individual carriers.

Since production will always equal capacity, there is no incentive for individual carriers to reduce tariffs to get more market share or more throughput.

The effect of this can be seen when Exxon and BP recently reduced their rates due to other considerations, not competitive considerations. When those rates were reduced, no other pipeline carrier followed. There was no incentive to do so.

Each carrier retained the same capacity and the same throughput as they had before the rate reduction. In fact, when the primary cause of that rate reduction was eliminated, the elimination of a court decree, a consent degree that limited tariffs, both Exxon and BP quickly raised the rates back up to the previously existing higher levels.

Thus it is well established that there is no competition that could pull tariff rates in check. The reason that this is important is that the Trans-Alaska Pipeline rates have a significant impact on the wellhead price of North Slope oil, the wellhead price being the price a producer would receive, an independent producer would receive for his oil.

Because there is no market in the field for North Slope oil, and in fact there is no real market in Alaska, the oil is first bought and sold in the lower 48, some thousands of miles from where it is produced.

The wellhead value, therefore, is deterimined by the price that the oil receives in the lower 48, minus the transportation charge to get the oil from the North Slope to the lower 48. The higher the transportation charges, the lower the wellhead price.

The reason the wellhead price is important is it is the most important number for the incentive to produce oil; and it is also the most important number for Federal and State taxes and royalties and other revenues from the oil production.

Higher tariffs mean lower wellhead prices; low tariffs mean higher wellhead prices. Unlike the lower 48, where oil pipeline tariffs only represent approximately 1.3 percent of the wellhead price, the TAPS tariffs, over $6 a barrel, represent one third of the wellhead price, a level twice as high as traditional utility type regulation would permit.

Tariffs at traditional regulatory levels would halve that amount presently, and have a substantial influence on tariffs in the future, and would result in a higher wellhead value, and, therefore, at least $25 billion more to State and Federal treasuries than would result if tariffs were set at noncompetitive or higher levels.

Second, the wellhead price determines the return or profit to independent or nonaffiliated producers, those who do not own a share of the pipeline.

Presently, the three largest owners of the pipeline are ARCO, Exxon and a combination of Sohio and British Petroleum. These are also the big three in terms of ownership or production from Prudhoe Bay and Kuparuk, the two presently reservoirs on the Alaskan North Slope.

To then profits at the wellhead or profits taken at TAPS are the same. And, in fact, for them it is better to have profits at the TAPS level because by doing so they avoid a higher tax rate, basically the windfall profits tax, and the State severance tax and the Alaska Royalty.

But many other reserves, or potential ANS reserves, are held or will be held by non-TAPS affiliated producers, by independent producers. The tariffs could and will make a tremendous difference in whether or not those reserves will produce oil at all, or the amount of production eventually given from those fields.

The difference between a proved, probable, and the amount of oil comes out of a reservoir depends upon the existing wellhead price for that oil.

Now, not only will more oil be produced if the rates are lower, but also more people will be selling that crude oil in the lower 48. As more people and more companies sell that crude oil, particularly on the west coast of the United States, more competition will result.

This will, in turn, lead to lower crude and oil product prices. Conservative estimates of the long-term impact of this increased competition and increased production are that approximately a billion barrels of recoverable Alaska crude oil will be produced because of the lower TAPS regulated rates, and the consumers will pay a billion dollars a year less in gasoline and other energy costs.

Therefore, whatever the arguments may be for deregulation of lower 48 pipelines, it is clearly in the national, State, and consumer interest to continue regulation of the Trans-Alaska Pipeline System along the lines proven to be effective for electric and gas utilities.

I would be pleased to answer any questions that the committee may have.

Mr. Anderson. Thank you, Mr. Maynard, for your presentation.

On page 2 of your statement, you comment on TAPS rates and say that in the absence of regulations, its tariffs would remain unreasonably high.

Late in your statement you say that the composite price for the transportation of a barrel of oil is $6.20. My first question is how much oil moves through TAPS on an annual basis?

Mr. Maynard. Approximately 1.6 million times 365. I think it's 534 million barrels.

Mr. Anderson. What rate does the State of Alaska believe should be charged for the transportation of a barrel of oil by TAPS?

Mr. Maynard. Approximately half that amount at present. Another——

Mr. Anderson. Like $3.10?

Mr. Maynard. $3.10. $3.50. It changes over time. One of the other major issues that we are litigating before the Federal Regulatory Commission is how that tariff moves over time. We believe that the tradition regulatory approach where the tariffs decrease over time——

Mr. Anderson. What was that volume of crude again?

Mr. Maynard. Let me check my calculator. That's 584 million barrels a year.

Mr. Anderson. So we're talking about $1.5 billion difference you think in terms of what the transportation costs should be from what it is?

Mr. Maynard. At least.

Mr. Anderson. At least. A billion and a half less money. In your opionion do you think that a lower transportation rate would result in the producer lowering the price of a barrel of oil by a corresponding amount?

Mr. Maynard. To the consumer in the lower 48? Not presently, no.

Mr. **Anderson**. No?

Mr. **Maynard**. Not presently. We think the long term effect over 10 years as it increases the wellhead value and brings more independent producers on stream, the increased amount of sales by other people. Right now most of the sales of Alaska North Slope crude are by three producers, Sohio, Arco, and Exxon. But that's a long term effect.

Presently we do not perceive of any short term effect on consumer prices.

Mr. **Anderson**. In your opinion, do you think that a higher transportation rate would result in the producer raising the price of a barrel of oil by a corresponding amount?

Mr. **Maynard**. No. Not presently. But over the long term, again, for the same reason. The effect of that, we believe, would prevent more independent producers from coming on stream with production. It would remain the concentration of the sales of Alaska North Slope oil in a few producers' hands. By doing that, that will have a long term effect of leading to higher prices than would otherwise be so.

But presently, no, it will not change one way or the other.

Mr. **Anderson**. Could you tell us how much of the domestic market is supplied by oil moving through TAPS?

Mr. **Maynard**. Eighteen percent of domestic oil production goes through TAPS. I don't know what the recent numbers are about total oil, both foreign and domestic, are. It's a somewhat lesser amount. I think it's more like 12 or 13 percent, or 10 percent.

Mr. **Anderson**. But on domestic, about 18 percent?

Mr. **Maynard**. Eighteen percent of domestic oil production goes through TAPS.

Mr. **Anderson**. Mr. Wolf?

Mr. **Wolf**. Thank you, Mr. Chairman. During the time the Alaska pipeline legislation went through, I remember there was some discussion of building an alternative line. Congressmen Udall and others had a line that would come down, cut through Canada and down through the Midwest. Is that idea totally dead?

Mr. **Maynard**. Yes, it is.

Mr. **Wolf**. Is there anything in the legislation? There must be something in the legislative history because it did take tremendous Federal involvement. I remember the administration at that time was very much involved in pushing this. Of course, it goes through all Federal lands.

That seems to make a pretty good case for what you're saying. But is there anything in the Federal law or in the legislative history that covers the points you're making about continued regulation? Anything in the legislative history or in any hearings?

Mr. **Maynard**. Not to my knowledge off the top of my head, no. The problem back then was, one, just getting a pipeline built, and two, where the oil would go, whether or not it was more needed on the west coast or the gulf coast, or the central part.

It has had the effect, however, there are different theories as to what's going on right now on the west coast market because of the oversupply of the NS crude oil on the west coast.

If it had gone to the Midwest, I don't think those theories, you wouldn't have those change in theories, maybe. But in the legislative history itself, I'm not aware of anything.

Mr. **Wolf**. You might want to check out the hearings. Mr. Melcher had extensive hearings. They went on for almost a couple of years. Maybe there is some indication that the corporations interested at that time said something indicating what they thought the future would be.

One other question: Since it did take a special Act of Congress to construct the pipeline, do you know of any other pipelines that have been built in this country that required a special act of Congress?

Mr. **Maynard**. No, sir. Not oil pipelines. There is a special act concerning the Alaska natural gas pipeline, but not oil pipelines.

Mr. **Wolf**. I have no further questions. Thank you, Mr. Chairman.

Mr. **Anderson**. Mr. Breaux?

Mr. **Breaux**. With regard to TAPS, I guess companies that are going to be able to sell the oil coming from the North Slope if it's at a price that's competitive with other sources of oil regardless of that price being made up of a high transportation cost, or a high wellhead price.

The person that's consuming North Slope oil in the lower 48 doesn't really care where the price is being made up from, whether it's high on the one end or low on the other end.

And is it not in your opinion in the company's interest to keep the price competitive with the lower 48, oil coming from imported oil or oil coming from the Gulf of Mexico?

Mr. **Maynard**. That is correct. The price of the crude oil in the lower 48, at least from the gulf coast, is clearly set by other factors than the TAPS tariff. On the west coast there may be less than perfect competition dealing with Alaska North Slope crude oil because of the concentration of the oil sales in a few producer hands.

But nonetheless, I don't believe that the TAPS tariff necessarily has an impact presently on the level of pricing except to the extent that there is some concern expressed by having a high TAPS tariff, that money is being shifted away from State and Federal monetary obligations and that allows some companies, perhaps, to continue a pricing of products that may be unavailable to other people. And that is a debate that is raging very seriously now before other committees and on the West Coast in lawsuits.

Beyond that generally your statement is correct, I believe. The price of oil when it reaches the lower 48, and particularly in the gulf coast, is set by other factors.

The concern that we have is that, our major concern is the effect of the TAPS tariff on the, basically the upstream effects, the effects on independent producers, and the effects on the State and Federal treasuries.

Whatever price is set in the lower 48, we believe that TAPS will be getting a disproportionate share of that amout to the detriment of nonaffiliated producers, to the detriment of the Federal Treasury, to the detriment of the State treasury.

Mr. **Breaux**. Is not your argument principally who is going to get the royalties, as far as if you keep the wellhead price up, Alaska certainly benefits a lot more, the U.S. Treasury benefits a lot more, and you're kind of backing into the competition argument as a way of maintaining the higher royalties for Alaska and for the U.S. Treasury. Would you be here today if you didn't get any royalty from that oil?

Mr. **Maynard**. In a sense, yes.

Mr. **Breaux**. In a sense. I bet you'd submit the statement instead of being here, though.

Mr. **Maynard**. No, it allows us to be able to pay the trip back here to make the testimony for sure. We have two definite interests. One interest is the present revenues that are being taken. A more important interest, and one that, in fact, our legislature rejected a possible settlement that was only 10 years in length, that would give us much more revenues than we're getting presently out of the line, because of the effect in the 1990's.

The State does have good revenue stream through the 1980's and into the early 1990's. But in 1995 we're in big trouble.

Mr. **Breaux**. Alaska?

Mr. **Maynard**. Alaska, yes. We have major problems starting in 1995.

Mr. **Breaux**. I bet you 49 other States would love to have your major problems.

Mr. **Maynard**. Presently I'm sure that's correct. I'm not too sure they want to trade places with us when we have nothing to replace Prudhoe Bay. The concern is bringing on other——

Mr. **Breaux**. We're trying to give you the Arctic National Wildlife Refuge.

Mr. **Maynard**. We'll take it.

The concern is production from fields in the future. That's, by the way, why—there are other protestants on this tariff besides the State of Alaska, and one of them is the Arctic native corporations. The Arctic Slope Native Corporation has spend millions of dollars in the case because they are extremely concerned, along with the State, about bringing on fields in the 1990's.

Because the tariff profile, without having low regulated tariffs in the 1990's, that many of their fields will not be economic. And that's a concern the State has.

So my answer is yes. We would be involved, or we would not maybe be able to afford the extent of the involvement that we have. But we would definitely be involved because of the interest in future production.

Mr. **Breaux**. What about the argument that the owners of TAPS, they're going to be interested in competition among themselves and part of that competition is reflected in the price that they would be willing to charge for the use of their pipeline.

You mentioned a lot of the independents. There's not an awful lot of independents that are producing oil in Alaska because of the high cost.

Mr. **Maynard**. Not right now. That's true. That's a concern of the future. Right now there are independents who have significant interests in other reserves, Melanie Point, the Outer Beaufort, Beaufort Sea, where they are expecting to bring their reserves on line in the 1990's.

And a major impact on their economics is what the tariff will be. The competition—our concern is that without regulated tariffs, the present pipeline owners have an artificial advantage in both bidding on and developing reserves for the North Slope.

And that overall will have bad effects for everyone. In fact, it will probably have worse effects on the Federal Government than it will have on the State solely because most of the undeveloped reserves in the late 1990's are Federal areas in the Outer Continental Shelf, like the Outer Beaufort.

Those appear to be the most prospective areas that would be the most sensitive to low tariffs in the 1990's.

Mr. **Breaux**. Is it not inconsistent for Alaska to strongly support the decontrol and deregulation of the price of oil and yet not to support the same for the transportation of that product?

Mr. **Maynard**. I'm not sure in what sense, because we believe that the decontrol of the price of oil also has a very major effect upon the ability to produce fields up in the North Slope. The higher the wellhead price, the higher the decontrol price of oil, the higher the wellhead price. The lower the transportation, the higher the wellhead price.

And therefore, the more likely and the more probable you will get the marginal fields on stream. So I think it is very consistent that we support both ends.

Mr. **Breaux**. You don't support it for TAPS.

Mr. **Maynard**. I'm sorry. Our major concern is that we support a high wellhead price. The components that make a high wellhead price are a high price in the lower 48 and a low transportation charge.

So therefore, we support regulated transportation charges that would keep them lower as if there would be competitive rates, like three or four separate pipelines. And higher prices in the lower 48, comparable to foreign prices.

Mr. **Breaux**. Do you think your position would be any different if the royalty was based on the TAPS price?

Mr. **Maynard**. Our position would still be the same because again we have the interest in the future production. We do have a property tax and we do tax the, and our income tax, the profits on the pipeline.

So, we do—the higher the tariffs and the more the revenue come through. Sometimes we would get a portion of that anyway.

Mr. **Breaux**. All right. Thank you very much. Thank you, Mr. Chairman.

Mr. **Anderson**. Thank you very much, Mr. Maynard and Mr. Wittow for your presentation.

Our final witnesses are a panel consisting of Mr. Don Merriman, president of Buckeye Pipe Line, for the Association of Oil Pipelines) (AOPL), and Mr. Edward J. Mitchell, professor of business economics, University of Michican, for AOPL, accompanied by Mr. Pat Corcoran, counsel for AOPL.

Just to get my statements here correct, Mr. Merriman, first I do have your prepared statement which will be made a matter of the record in its entirety. Then I have a note from Mr. Pat Corcoran who says that he will be presenting the pipeline industry's critique of the paper prepared by Mr. James Love, of the Center for the

Study of Responsive Law. Then I have the testimony of Edward J. Mitchell, and then a NERA Study of Competition in Oil Pipeline Markets: A Critique, also by Mr. Mitchell.

And in your packet of material here I have an analysis of the bill. I'm not exactly sure who that was from.

Mr. MERRIMAN. That was part of my submittal.

Mr. ANDERSON. OK.

The full text of your prepared statements and other items will appear in the record at this point.

[Statements referred to follows:]

STATEMENT OF DONALD R. MERRIMAN
BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION
SUBCOMMITTEE ON SURFACE TRANSPORTATION

My name is Donald Merriman. I appear today in support of HR 2677 on behalf of the Association of Oil Pipe Lines (AOPL), an unincorporated association of ninety common carrier oil pipeline companies whose members transport approximately 95 percent of all crude oil and refined petroleum products moved by pipeline in interstate commerce. With me is Patrick Corcoran, Counsel to the Association. I am an officer of AOPL and also President of Buckeye Pipe Line Company, an independent petroleum pipeline company operating in the northeast quadrant of the United States. My company is not affiliated with any integrated petroleum company.

Also, appearing here today are the authors of two studies on competition in the oil pipeline industry, Professor Edward J. Mitchell of the University of Michigan, who has completed a study for the AOPL of oil pipelines in the lower forty-eight states, and Mr. Richard J. Barber, President of Richard J. Barber Associates, who has completed a study of the Trans Alaska Pipeline System (TAPS) which was commissioned by the eight carriers owning undivided interests in TAPS.

I will mention some of the salient features of the oil pipeline industry, contrast them with the gas pipeline industry, and explain why the proposal for economic deregulation of oil pipelines is a nonrevolutionary but very necessary protective measure.

The U.S. oil pipeline industry represents an investment of twenty billion dollars by the private sector. Now in its 118th year, the industry is comprised of 227,000 miles of pipe and a multiplicity of pumping stations, working tankage, and delivery facilities. There are three categories of oil pipelines. 68,000 miles of crude oil gathering lines collect oil from individual producing wells or fields and deliver it either to nearby refineries or to crude oil trunk lines. There are some 78,000 miles of these trunk lines which extend generally over long distances from major producing areas or deepwater ports to refining centers. From refineries, where the crude oil is converted to consumer products, 81,000 miles of refined products lines deliver gasoline, home heating oil, kerosene, aviation jet fuel, and other products to consuming markets.

Since the majority of its facilities are underground, silent and unseen, and its customers are petroleum refiners; marketers; or large volume users such as airlines, railroads, or trucking firms, the industry is generally not well known, yet it is vital to our Nation's economy. It carries approximately one quarter of all inter-city freight in this country, on a ton-mile basis, yet at only 3.3 percent of the Nation's freight bill. Crude oil pipelines carry nearly 60 percent of all crude barrels moved, while refined products pipelines move over 40 percent of all petroleum products barrels and these pipelines are in vigorous competition with each other. Additionally, in both cases waterborne carriers are major competition as well as other modes of transportation.

It is essential to keep in mind that oil pipelines are a distinctly different industry from gas transmission lines. Only the hardware is similar. Under the Interstate Commerce Act, entry into (and exit from) the oil pipelines business is unrestricted. Unlike gas transmission lines, no certificate of public convenience and necessity is required before a line can be built. Nor do oil pipelines need permission to abandon service. Unlike gas transmission lines, oil pipelines have no franchised area, no legally assigned market; gas lines do. Instead, oil pipelines act as common carriers, and title to the product they carry remains with the shipper, whereas gas pipelines typically own the gas they transport. Oil pipelines are not public utilities, gas pipelines are.

The chief result of this industry's structure is that competition not regulatory policy, is the primary determinant of oil pipeline rates. Competition has led to winners and losers in our business, just as in any free market industry, and, today, some oil pipelines are losing money because of competition. Returns in the oil pipeline industry are roughly equal to those in the competition sectors of American industry generally.

Another result of common carrier status is that anyone who makes a proper tender of a shipment must have his oil carried on the same terms as everyone else similarily situated; i.e., at the same rates and under the same rules and regulation, regardless of whether the shipper is large or small or whether the shipper is affiliated with the pipeline company or not. Thus, there can be no preferred customers.

Since they were the ones with the principal need to move crude and refined products, it is not surprising that the primary investors in oil pipelines are the major integrated oil companies. There are also many other owners, such as small refiners and those who have little interest in other facets of the petroleum industry. My company is one of the latter "independents." Some oil pipelines are joint ventures of a number of pipeline companies and may include refiner/marketers.

But no matter what the form of ownership, in virtually every case, new oil pipeline construction projects must compete for funds within their corporate hierarchies against other profit making projects or acquisitions. Because of their competitive risk, they must be able to show a likelihood of returning competitive earnings or they will not be built.

So much for the structure of the industry.

If you look at the history of how this structure came into being you can see that removal of pricing jurisdiction from the Regulatory Commisssion is not as radical a change as you might think.

As to the legislative history of the industry, it is clear that the 1906 Hepburn Act was aimed principally at strengthening the Interstate Commerce Commission's powers to correct the discriminatory abuses prevalent in the railroad industry. Oil pipelines were added almost as an afterthought. There were no hearings on oil pipelines being brought under the Interstate Commerce Commission and very little debate. The Congressional concern was not with the level of the transportation charges but rather with protecting shippers from discriminatory practices. The 1906 "Report of the Commissioner of Corporations on the Transportation of Petroleum" made this clear when it said (at Page 34):

> "It is the difference between rates, not the rates themselves, which are of special importance."

Retention of common carrier obligations, as provided in HR 2677, will continue the anti-discrimination sections of the law.

Indeed, recognizing the Congressional intent and understanding nature of the industry, the ICC employed a light regulatory hand for decades during which shipper complaints were practically nonexistent. The success of that policy is evident in the viable, efficient, and competitive industry which today exists in this country.

In November of last year, the Federal Energy Regulatory Commission issued a landmark decision in the Williams case intended to establish a new economic framework within which the industry could operate. During the lengthy hearings which led to the Williams opinion and in hearings held on economic deregulation in the last Congress, no one appeared citing any concern by the ultimate consumer of petroleum products. Oil pipeline charges are a de minimis amount of the end-cost to the consumer . . . a fact that has been documented several times. In a 1980 decision, the FERC stated that not only is a pipeline charge a miniscule part of the consumer's total oil cost, but that end-cost is in fact set by much larger market forces that make a pipeline rate increase, or decrease, " . . . inaudible . . if it is not wholly lost in the surrounding noise." This viewpoint was reiterated in the recent Williams decision, which noted that the cost to the consumer of total pipeline transportation throughout the Continental United States is only 1.5 cents per gallon. Furthermore, a recent DOE study examined the effect of pipeline deregulation on consumers costs and found that, even if regulation could be credited with restraining pipelines rates by 20 percent, the savings to the consumer would be two-tenths of one cent per gallon. Likewise, the study noted that, even if deregulation resulted in increased rates, the range of impact on the consumer would not even exceed 1 cent per gallon.

The proposed deregulation would, therefore, not constitute an abrupt change. Its effect on the industry would be to ensure the continuance of competition among common carriers free from strangulation by regulation. Its effect on consumers would range from invisible to nothing at all. It is not revolution but protection that we seek.

I have been in the oil pipeline business for 34 years, a period of expansion and technological improvement which has resulted in the finest petroleum transportation network of any nation in the world. However, the last half dozen years have seen our industry operating under uncertain conditions, mired in a regulatory morass with uncounted resources of time and money turned away from our basic business.

The Williams decision is now before the United States Court of Appeals for the District of Columbia. The same case was before that Court five years ago. If the past is prologue, we still have before us years of judicial and administrative proceedings before a final decision is reached. Even then the rules will be subject to constant "reinterpretation" by an agency best acquainted with strict public utility concepts, concepts which are proving questionable even when applied to real public utilities and which would be disastrous for oil pipelines.

Accordingly, we come to the Congress and ask that through legislation it cut the Gordian knot. The FERC in its decision suggested that it was timely for this body to consider deregulation of the indsutry; and in other hearings the Department of Energy, the Department of Justice, and the Office of Management and Budget have basically endorsed this approach.

Members of this Committee have introduced appropriate legislation, and the AOPL enthusiastically endorses HR 2677. This bill, which we unanimously support, would economically deregulate the industry by eliminating regulatory authority to set the level of rates while providing protection to shippers by continuing our common carrier obligations under the Interstate Commerce Act.

We are convinced that not only does the spirit of this bill eliminate unnecessary regulation and provide appropriate shipper protection, but also that the technical language of the bill satisfactorily either repeals or amends sections of the Department of Energy Organization Act and the Interstate Commerce Act to accomplish this purpose. Furthermore, this bill does not exclude any oil pipelines from its provisions. A detailed analysis of HR 2677 and what it does and does not do is appended to this statement.

I mentioned earlier that the Department of Energy and the FERC, the Department of Justice, and the Office of Management and Budget have all supported deregulation of oil pipelines, at least in the lower 48 states.

Indeed, the Justice Department (and others) have proposed total deregulation in order to ensure more perfect competition. That is, to allow discrimination among shippers and to prohibit the publication of tariffs. We have yet to see a draft of legislation delineating the details of total deregulation, but we can foresee problems. In order to construct a pipeline, it is necessary to be able to condemn a right of way. The right of condemnation is based on the concept that the facility will "serve the public." Total deregulation would mean that pipelines could be "privatized." That is, they could refuse to ship anyone's oil except their owner's and hence would not be serving the public. It would then be difficult to justify their having the right to condemn.

The ability to exclude others from service or to offer different terms to different shippers for the same service could have far-reaching and unfortunate consequences. This type of discrimination caused the evils that the Hepburn Act cured. The anti-discriminatory portions of that Act should not be removed just in order to provide a more theoretically perfect model of competition.

The ability to change tariff rates without prior notice could have an adverse impact on shippers. Today a shipper can analyze the competitive routes and modes available to get his material to market and choose the one that best suits his needs. The transit time from origin to ultimate destination, however, may be in excess of four weeks with a number of carriers involved in the routing. Once having committed a shipment to a particular routing, a change in rate by one of the carriers in that routing, or by a carrier in an alternative routing not chosen, may cause a shipper to incur higher transportation charges than either he thought he would, or were available to him. We believe that the transit times in interstate commerce make it essential to retain the advance notice of rate adjustments.

In addition, in one fashion or another Justice Department and others have suggested that the industry be deregulated on a pipeline by pipeline basis or that it be deregulated subject to reregulation if a pipeline were shown to have monopoly power. We cannot reach a conclusion on these ideas or comment until we have specific proposals to study.

At first blush, however, we feel that such ideas could cause dislocations within the industry. Pipelines are rarely discrete units going from A to B. They are more typically interconnected and in competition with each other and with others modes of transportation. To create a situation in which part of this network is regulated while the rest is not would be to risk havoc. Simply trying to determine just which lines, systems, segments of lines, specific movements, etc. might be apppropriate for reregulation and which might not could create a new regulatory mess and renewed uncertainties for decades to come.

The industry is concerned with the continued development of "frontier" pipelines. These are the pipelines for which there will be a need in the future - to connect new sources of supply in remote and hostile environments - offshore, in the Arctic, and in previously unconnected areas of the lower 48. They will be considerably more expensive on a unit basis than the existing pipeline network and may require innovative construction techniques. Our position is that investors in these facilities should be able to earn rewards commensurate with the huge risks taken and not be fettered by utility regulatory concepts or the parochial interests of any entity.

We believe that the continuation of economic regulation for these "frontier" oil pipelines will inhibit their development, thus stifling the very projects that will be most needed in the future.

Let me summarize: We believe economic deregulation of oil pipelines is necessary in order to avoid the stifling of the industry. The Hepburn Act bringing oil pipelines under the Interstate Commerce Commission was not primarily concerned with rate levels but with discrimination among shippers leading to monopolization of the oil industry. Oil pipeline rate levels are far less significant to consumers now than they were then. The industry is now sufficiently competitive so that the market has been restraining rates, not the regulatory body. But narrow public utility regulation and the uncertainties of the regulatory process remain a threat to the vitality of the industry. HR 2677 provides the necessary economic deregulation yet retains the anti-discrimination protection of common carriage. We believe that this bill merits your support.

ANALYSIS OF BILL

Section 2 - Section 2 is a declaration of legislative policy. It makes explicit congressional policy to foster competition in the oil pipeline industry, prevent discrimination, induce investment in oil pipelines and eliminate unnecessary regulation.

Section 3 - Section 3(a) repeals Section 306 of the Department of Energy Organization Act (DOE Act). Section 306 transferred to the Secretary of Energy (the Secretary) the functions set forth in the Interstate Commerce Act (ICA) and vested in the Interstate Commerce Commission (ICC) relating to transportation of oil by pipeline.

Section 3(b) repeals Section 402(b) of the DOE Act. Section 402(b) transferred to the Federal Energy Regulatory Commission (FERC) all functions and authority of the ICC relating to the regulation of rates for the transportation of oil by pipeline and the valuation of oil pipelines.

Section 3(c) amends Section 402 of the DOE Act by adding a new paragraph vesting in the FERC all functions which were transferred to the Secretary under Section 306 and to the FERC under Section 402(b).

Section 4 - Section 4 is a section-by-section amendment of the ICA to accomplish the bill's purposes. In addition to the amendments discussed below provisions which refer only to railroads, such as references to "fares", have been deleted from the amended sections. Those provisions have already been repealed by Section 4 of the Revised Interstate Commerce Act, although the language of the ICA was not revised to reflect that repeal.

Section 1(4) of the ICA is amended to delete the requirement that oil pipeline rates and the divisions of joint rates must be just and reasonable. This is consistent with the intention to allow the level of such rates to be determined by market forces.

Section 1(5)(a), which requires that all charges be just and reasonable and that unjust and unreasonable charges are unlawful, is repealed.

Section 13(4) deals with the duty of the FERC where state regulations result in discrimination or impose an undue burden on interstate commerce. The statute is amended to eliminate the FERC's power to prescribe pipeline rates in place of those set by a state. The FERC retains its authority to set such rates aside if it finds them to be discriminatory and to prescribe regulations and practices where the state-prescribed regulations result in discrimination.

Section 15(1) is amended to delete the power of the FERC to prescribe rates. If the FERC determines that a rate is discriminatory it may order the carrier to cease and desist from charging discriminatory rates. In that event it would be up to the carrier to adjust its rate structure to comply with the FERC's order. If the FERC finds that a regulation or practice is unjust it may prescribe a just regulation.

Section 15(3) is amended to delete the FERC's authority to establish joint rates. The FERC retains its authority to establish through routes.

Section 15(6) sets forth the FERC's authority to establish just divisions of joint rates. It is repealed.

Section 15(7) deals with hearings on newly-filed rates. It is amended to delete the FERC's authority to determine whether any new rate is just and reasonable and to eliminate the FERC's authority to suspend rates pending such determination. The FERC retains the authority to hold hearings to determine whether a rate is unjustly discriminatory and whether a regulation or practice is unlawful. It may suspend the operation of a regulation or practice for a period of seven months, just as under the present statute.

49 U.S.C. § 65(a) is repealed, since it is simply a supplementary statute dealing with the matters which should be considered when prescribing just and reasonable rates.

Section 5 - This is a new section which preempts state regulation of interstate transportation of oil.

Section 6 - The Act shall take effect 60 days after the date of its enactment.

TESTIMONY OF EDWARD J. MITCHELL
PROFESSOR OF BUSINESS ECONOMICS
UNIVERSITY OF MICHIGAN
BEFORE THE
SUBCOMMITTEE ON SURFACE TRANSPORTATION
HOUSE PUBLIC WORKS COMMITTEE

Mr. Chairman and Members of the Committee:

I appear before you today on behalf of the Association of Oil Pipe Lines (AOPL) to discuss why oil pipelines should no longer be subject to price or rate regulation by the Federal Energy Regulatory Commission. My remarks are based primarily on research I conducted for AOPL on competition in the oil pipeline industry. My report entitled, "A Study of Oil Pipeline Competition," has been submitted to the Subcommittee for inclusion in the record of these hearings. My comments today will therefore merely summarize what I conclude from that study.

It might seem at first glance that oil pipeline deregulation is just another in a series of attempts to return the transportation sector of the American economy from the heavy hand of bureaucracy to the efficiency of the marketplace. This characterization would be totally misleading. Unlike the airlines, the railroads or trucking, the oil pipeline industry has not been burdened by highly restrictive regulation. Oil pipeline companies do not require a certificate of convenience and necessity to construct a new pipeline or to extend or shut down an existing line. There has always been freedom of entry and exit. Regulation has not imposed maximum or minimum prices or rates, or restricted oil pipeline profitability, either through floors or ceilings.

The purpose of the legislation before us is to ensure that oil pipelines remain in the unregulated sector, except for the provisions of the Interstate Commerce Act prohibiting discrimination among shippers. Since the transfer of regulatory authority over the industry from the ICC to the FERC there has been a continuous attempt to characterize oil pipelines as natural monopolies, subjecting them to cost-of-service pricing and the associated paraphernalia of public utility regulation. While a favorable outcome in the Williams case would ease the threat of rate regulation it would not eliminate it. If a particular commission and staff can seriously threaten to impose public utility regulation under the existing law, then even if that threat is removed by the current commission it would not necessarily imply permanent relief. Now that this fear is planted in the minds of the industry, all future decision about pipeline investments, which will last 50 or more years, will be affected unless the threat is once and for all exorcised by legislation.

What makes it easier for Congress to act on this issue is that it will not be moving from the known of regulation to the unknown of the market as it did in the other transport industries. Rather it will be insuring a continuation of a past characterized by growth of the pipeline network, increasing economies of transport, competition, and profits in line with risk. What we can expect then is more of the same, and therefore the only issue I perceive is whether a continuation of the past is what we want in the future.

The most important question regarding the past is whether the industry has been competitive and can be expected to remain so. There is presumptively no reason to regulate the prices of a competitive industry.

The following evidence supports the competitiveness of oil pipelines:

Pipelines typically face a number of rivals. In the 59 largest metropolitan areas, those served by at least one product pipeline are served by an average of 1.6 local refineries and 3.0 product pipelines, a total of 4.5 independent competing entities (allowing for the fact that a few of the refineries and pipelines are commonly owned). In addition, about 90 percent of the population of these cities has access to water transportation. The cost of moving oil by barge and tanker is in about the same range as the cost of moving oil by pipeline. Thus, we find that within the United States half of all refined product and crude oil by ton-mile were moved by water in 1980. This does not include movement of foreign oil into the United States, which would be two and a half times this much again.

The barge and tanker industries are highly competitive and can be characterized as atomstic, that is, the largest firms account for a very small percentage of total capacity. (The oil industry as a whole owns only 13 percent of the barge capacity and 20 percent of the tanker capacity).

Thus, a product pipeline would normally face substantial competition even if it were the only pipeline serving a particular market.

In the few cities over 500,000 that are not served by water transport the average number of local competing entities (refiners plus product pipelines) is 5.4, somewhat larger than the number serving cities with water access.

There are, of course, places where the number of rivals is less than average. I have investigated all those cases where a single product pipeline serves a community of 500,000 or greater. In most of these places water transport of gasoline and distillate represents a large fraction of local consumption (at least 43 percent and 34 percent, respectively). In the other cases there are either a large number of local refineries, or a combination of actual or potential competition that suggests little or no potential for the exercise of monopoly power.

I have examined pipelines collecting crude oil in areas representing 98 percent of the lower 48 domestic production, and refinery centers representing 92 percent of lower 48 refinery capacity. Looking at either the average, or the "worst" cases, from a competitive point of view I find again little or no potential for the exercise of monopoly power by oil pipelines.

In all I examined 182 market niches and found that oil pipelines typically face substantial competition.

One may ask whether very small consuming markets not covered by my study might be more likely to face monopoly power. This seems improbable. By and large product pipelines are designed to take oil from major refining centers to major consuming centers. Because of the small volumes moving to small markets, pipelines are generally uneconomical in those markets and distribution is instead carried out by truck from major pipeline terminals. An exception would be where a pipeline passes through a small community on its way to a larger one, and where the small community has sufficient volume to justify a local terminal. In this case, even if the pipeline in question did not face competition from competing pipelines or from water transport, it would be subject to the long haul-short haul clause of the Interstate Commerce Act which requires that rates to terminals along a line be no more than rates to more distant terminals on the same line. Thus, the force of competition in the major markets will also be transferred back to smaller markets along the line.

The effects of oil pipeline competition show up in the profit statistics of the industry. The delevered average rate of return on total capital for the industry is close to the average of all manufacturing industries. Statistical estimates of the risk faced by oil pipeline companies also place them in the category of about average. However, unique institutional circumstances in the pipeline industry, notably, the extreme debt financing and the throughput guarantees induced in the past by the Elkins Act Consent Decree, caused the traditional statistical estimates of risk to understate the risk to owners of oil pipelines. Thus, I would characterize the industry as being above average in risk. The combination of average profits and above average risk is consistent with prevalence of competition.

An arguement can be raised as to whether the profitability of the industry is normal because the ICC, the FERC, or the Elkins Act Consent Decree has held profits down. My analysis of the profit data shows no evidence that the ICC or the FERC has constrained industry profits. And cases where the consent decree may have significantly constrained profits appear to be uncommon. Thus, the profits and tariffs that we observed historically are due primarily to competitive conditions, not regulation.

The belief that pipeline rates should be regulated derives from the theory of natural monopoly, which states that unlimited economies of scale lead to a single firm dominating a market.

While it is true that oil pipelines involve technical economies of scale with respect to pipe diameter, the various assumptions needed to get from that fact to monopoly are not valid in the case of oil pipelines. Most markets are served by several oil pipelines. And if pipeline scale were a major determinant of competitive standing in the industry, it should account for an appreciable fraction of the widely varying company profit rates. It does not. At most, scale, as measured by pipe size, explains only a very small fraction of the varying degrees of success that pipelines experience. Rather, it would appear that building the right sized line in the right place at the right time with the right package of service is what determines success.

The oil pipeline industry is competitive now, but what about the future? Certain technical and economic facts make it likely that the level of competition will grow, as it has continually done in the past. First, pipelines are durable. Some pipelines laid before the Standard Oil divestiture in 1911 are still in operation, and many active pipelines are more than fifty years old. Second, operating costs represent less than half of total costs. Thus, a pipeline could with time turn out to be a poor investment for the owner yet still be more economical in operation than shut down.

Because the attrition rate of oil pipelines is so low new pipelines have been added at a rate more than ten times as great as the rate at which old pipelines have been retired. Between 1968 and 1979, less than 3 percent of pipeline capacity (as measured by barrel-miles) was retired. And because new pipeline companies have entered at a significant rate the pattern of ownership of pipelines has been becoming increasingly diversified with time. The share of the 4 largest pipeline owners in total industry capacity has been falling at the rate of 5 percentage points per decade for about 3 decades, and is now at about 30 percent.

Since the technical and economic conditions underlying this trend are still in effect the expectation is that the pipeline industry will become only more competitive with time.

* * * * *

In April 1983 the National Economic Research Associates (NERA) released a report authored by Robert E. Anderson and Richard T. Rapp entitled *Competition in Oil Pipeline Markets: A Structural Analysis*. The report is in large part a response and rebuttal to my *A Study of Oil Pipeline Competition*.

The major points of the NERA report are:

(1) oil pipeline markets are commonly so concentrated as to be regarded as "uncompetitive," raising the possibility of monopoly prices and profits if unregulated;

(2) water transport and trucks are generally not competitive with pipelines;

(3) oil pipeline profitability studies are inconclusive;

(4) economies of scale and vertical integration support and compound, respectively, the monopoly problem.

In general, my response to the NERA report is that its conclusions are not valid because (a) its assumptions are often unrealistic, (b) its economic reasoning is at times erroneous, (c) its characterization of some of the literature is misleading, (d) its discussion is often speculative when hard data are available, (e) contrary empirical evidence is at times ignored, and (f) its detailed statistical work and market analyses have not been released, making verification of its scientific integrity impossible.

In particular, the report is criticized as follows:

(1) The report assesses competition and market power solely on the basis of the concentration theory admitting that this theory is controversial. The authors seriously undercut their own faith in this theory by questioning the value of profitability data that are the sole empirical basis for the concentration theory. NERA then adopts a concentration standard for competitiveness that would assign perhaps one-third of U.S. manufacturing industry to the category of "uncompetitive," and thus as candidates for regulation. While standards like these have been proposed before they have been continuously rejected by the Congress of the United States and are inconsistent with U.S. economic and industrial policy.

(2) NERA attempts to characterize studies of the profitability of the oil pipeline industry as inconclusive. Yet this result can only be achieved by accepting studies that are methodologically in error and ignoring more careful and sophisticated research. On the contrary, properly done studies all show that oil pipeline profitability is appropriate for the risk of the industry and therefore consistent with competition in the pipeline marketplace.

NERA also characterizes discussions of the effects of ICC guidelines on profitability as inconclusive without any detailed discussion of methodology. Yet detailed analysis easily accounts for the differences in conclusions, leading to the view that the ICC guidelines had no significant effect on profitability.

(3) NERA argues that barges cannot compete with pipelines in the movement of crude oil and petroleum products. This argument is supported by a series of tables showing that atypically low cost, large-scale pipelines have lower costs per mile than typical barges. This conclusion is obviously not valid, but it is also totally inconsistent with NERA's own approach since: (a) NERA emphasizes very small markets typically served by small high cost pipelines; and (b) NERA rejects the "corridor" approach in favor of the "origin-destination" approach in which costs per barrel mile are substantially irrelevant.

Although overall national statistics show pipelines and water transport carry about equal volumes of oil, NERA attempts to make water transport disappear by focussing on a few highly aggregative instances where water shipments are below average. In no case does NERA actually measure water shipments of crude oil or product into the hundreds of markets NERA analyzes. Such data are readily available and were widely used in my study, leading to the conclusion that water transport was typically a major competitive factor in markets characterized by lower than normal pipeline competition.

(4) The NERA measurement of concentration and its assessment of competition in specific markets is criticized as follows:

(a) NERA simply assumes many markets where water competition exists to be uncompetitive without ever actually measuring the degree of water competition and in spite of the fact that I found in my study that water competition often dominated in these markets.

(b) NERA ignores local sources and outlets for refiners unless these exceed in volume the refiners' capacity. Besides evidencing a serious error in economic logic this assumption relegates to the uncompetitive class markets where pipelines may play a very small role.

(c) NERA restricts the size of the market to the county in the case of crude production, and to the Bureau of Economic Analysis (BEA) areas defined by the Department of Commerce in the case of consuming markets, with little argument as to why the market should be so small. Supporting argument comes from just one sentence restricting economical trucking distance to 50 miles. But typical trucking distances in low density markets are often much greater than this. Detailed analysis of a few small consuming markets characterized by NERA as high risk shows that the viable competing entities in the market rise sharply when actual or reasonable trucking distances are used. Puzzling also is the fact that some NERA consuming centers characterized as having a high risk of monopoly exploitation by pipelines do not have a pipeline delivering product within the 50 mile limit.

(d) While measuring the concentration of pipelines in a refining center NERA does not measure the concentration of refiners on the other side of the market. Based on the data assembled in my report (which NERA also relies on) I find that refiners are at least as concentrated as pipelines, probably somewhat more so, suggesting in the typical case little problem of exploitation by pipelines of refiners, regardless of the absolute degree of concentration present. These markets account for two of the four categories of markets considered in the NERA study.

Furthermore, in computing concentration in consuming markets NERA does not conclude that high concentration would imply regulating refiners as well as pipelines, since the two are lumped together as competitors. In my study I observed that pipelines contributed more to competition in these markets than refiners suggesting that it would be more logical to regulate refiners than pipelines. NERA does not pursue the implications of their findings.

(e) Pipeline concentration in consuming markets is enormously overstated because NERA assumes that each pipeline's deliveries are proportional to its capacity. Yet no pipeline has deliveries approaching capacity at all its terminals. Based on logic and an example we conclude that NERA is likely to overestimate each pipeline's role by a factor approximately equal to the number of terminals that the pipeline has. Furthermore, this bias is likely to be greater for larger pipelines. We conclude that the role of pipelines relative to refineries is likely to be overestimated several-fold.

(f) NERA acknowledges that vertical integration between a refiner and pipeline eliminates the problem of monopoly exploitation. Yet NERA does not adjust its concentration figures for this fact. In my study I found that perfect vertical integration occurred in most of the "worst case" refiner markets and that there was a high degree of vertical integration in a portion of the remaining cases. Indeed, it is probable that something like three-fourths of all oil shipped by pipeline is owned by the owner of the pipeline. The extent of potential monopoly exploitation even in cases of extreme concentration would therefore seem to be small, especially since these are the cases most likely to show a high degree of vertical integration. Again, NERA simply ignores this in its tables and charts displaying competition in the industry.

(g) NERA assumes that pipeline companies that share any degree of ownership in a joint venture or undivided interest line are in perfect collusion and treats each pipeline company and the joint venture as a single entity. No logical or empirical basis for this assumption is offered. The Department of Justice has been investigating joint venture pipelines continuously for decades. No such conspiracy has ever been detected. NERA assumes that they are not only occurring every day throughout the nation but that they are perfect conspiracies, something economists have thus far never observed.

The upshot of all these systematic biases toward finding concentration and monopoly power is that their true presence must be overestimated many times. Indeed, several of these biases alone could raise estimated concentration and monopoly power several-fold.

We conclude that the NERA report, primarily because of its unrealistic approach, does not offer a valid basis for judging competition in the oil pipeline industry.

THE NERA STUDY OF COMPETITION IN OIL PIPELINE MARKETS: A CRITIQUE

by

EDWARD J. MITCHELL

October 1983

I. Summary and Conclusions

In April 1983 the National Economic Research Associates (NERA) released a report authored by Robert E. Anderson and Richard T. Rapp entitled Competition in Oil Pipeline Markets: A Structural Analysis.[1] The report is in large part a response and rebuttal to my A Study of Oil Pipeline Competition.[2]

The major points of the NERA report are:

(1) oil pipeline markets are commonly so concentrated as to be regarded as "uncompetitive," raising the possibility of monopoly prices and profits if unregulated;

(2) water transport and trucks are generally not competitive with pipelines;

(3) oil pipeline profitability studies are inconclusive;

(4) economies of scale and vertical integration support and compound, respectively, the monopoly problem.

In general, my response to the NERA report is that its conclusions are not valid because (a) its assumptions are often unrealistic, (b) its economic reasoning is at times erroneous, (c) its characterization of some of the literature is misleading, (d) its discussion is often speculative when hard data are available, (e) contrary empirical evidence is at times ignored, and (f) its detailed statistical work and market analyses have not been released, making verification of its scientific integrity impossible.

---

[1] R.E. Anderson and R.T. Rapp, Competition in Oil Pipeline Markets: A Structural Analysis, National Economic Research Associates (April 20, 1983), mimeo.

[2] E. Mitchell, A Study of Oil Pipeline Competition (April 1982) mimeo.

In particular, the report is criticized as follows:

(1) The report assesses competition and market power solely on the basis of the concentration theory admitting that this theory is controversial. The authors seriously undercut their own faith in this theory by questioning the value of profitability data that are the sole empirical basis for the concentration theory. NERA then adopts a concentration standard for competitiveness that would assign perhaps one-third of U.S. manufacturing industry to the category of "uncompetitive," and thus as candidates for regulation. While standards like these have been proposed before they have been continuously rejected by the Congress of the United States and are inconsistent with U.S. economic and industrial policy.

(2) NERA attempts to characterize studies of the profitability of the oil pipeline industry as inconclusive. Yet this result can only be achieved by accepting studies that are methodologically in error and ignoring more careful and sophisticated research. On the contrary, properly done studies all show that oil pipeline profitability is appropriate for the risk of the industry and therefore consistent with competition in the pipeline marketplace.

NERA also characterizes discussions of the effects of ICC guidelines on profitability as inconclusive without any detailed discussion of methodology. Yet detailed analysis easily accounts for the differences in conclusions, leading to the view that the ICC guidelines had no significant effect on profitability.

(3) NERA argues that barges cannot compete with pipelines in the movement of crude oil and petroleum products. This argument is supported by a series of tables showing that atypically low cost, large-scale pipelines have lower costs per mile than typical barges. This conclusion is obviously not valid, but it is also totally inconsistent with NERA's own approach since: (a) NERA emphasizes very small markets typically served by small high cost pipelines; and (b) NERA rejects the "corridor" approach in favor of the "origin-destination" approach in which costs per barrel mile are substantially irrelevant.

Although overall national statistics show pipelines and water transport carry about equal volumes of oil, NERA attempts to make water transport disappear by focussing on a few highly aggregative instances where water shipments are below average. In no case does NERA actually measure water shipments of crude oil or product into the hundreds of markets NERA analyzes. Such data are readily available and were widely used in my study, leading to the conclusion that water transport was typically a major competitive factor in markets characterized by lower than normal pipeline competition.

(4) The NERA measurement of concentration and its assessment of competition in specific markets is criticized as follows:

(a) NERA simply assumes many markets where water competition exists to be uncompetitive without ever actually measuring the degree of water competition and in spite of the fact that I found in my study that water competition often dominated in these markets.

(b) NERA ignores local sources and outlets for refiners unless these exceed in volume the refiners' capacity. Besides evidencing a serious error in economic logic this assumption relegates to the uncompetitive class markets where pipelines may play a very small role.

(c) NERA restricts the size of the market to the county in the case of crude production, and to the Bureau of Economic Analysis (BEA) areas defined by the Department of Commerce in the case of consuming markets, with little argument as to why the market should be so small. Supporting argument comes from just one sentence restricting economical trucking distance to 50 miles. But typical trucking distances in low density markets are often much greater than this. Detailed analysis of a few small consuming markets characterized by NERA as high risk shows that the viable competing entities in the market rise sharply when actual or reasonable trucking distances are used. Puzzling also is the fact that some NERA consuming centers characterized as having a high risk of monopoly exploitation by pipelines do not have a pipeline delivering product within the 50 mile limit.

(d) While measuring the concentration of pipelines in a refining center NERA does not measure the concentration of refiners on the other side of the market. Based on the data assembled in my report (which NERA also relies on) I find that refiners are at least as concentrated as pipelines, probably somewhat more so, suggesting in the typical case little problem of exploitation by pipelines of refiners, regardless of the absolute degree of concentration present. These markets account for two of the four categories of markets considered in the NERA study.

Furthermore, in computing concentration in consuming markets NERA does not conclude that high concentration would imply regulating refiners as well as pipelines, since the two are lumped together as competitors. In my study I observed that pipelines contributed more to competition in these markets than refiners suggesting that it would be more logical to regulate refiners than pipelines. NERA does not pursue the implications of their findings.

(e) Pipeline concentration in consuming markets is enormously overstated because NERA assumes that each pipeline's deliveries are proportional to its capacity. Yet no pipeline has deliveries approaching capacity at all its terminals. Based on logic and an example we conclude that NERA is likely to overestimate each pipeline's role by a factor approximately equal to the number of terminals that the pipeline has. Furthermore, this bias is likely to be greater for larger pipelines. We conclude that the role of pipelines relative to refineries is likely to be overestimated several-fold.

(f) NERA acknowledges that vertical integration between a refiner and pipeline eliminates the problem of monopoly exploitation. Yet NERA does not adjust its concentration figures for this fact. In my study I found that perfect vertical integration occurred in most of the "worst case" refiner markets and that there was a high degree of vertical integration in a portion of the remaining cases. Indeed, it is probable that something like three-fourths of all oil shipped by pipeline is owned by the owner of the pipeline. The extent of potential monopoly exploitation even in cases of extreme concentration would therefore seem to be small, especially since these are the cases most likely to show a high degree of vertical integration. Again, NERA simply ignores this in its tables and charts displaying competition in the industry.

(g) NERA assumes that pipeline companies that share any degree of ownership in a joint venture or undivided interest line are in perfect collusion and treats each pipeline company and the joint venture as a single entity. No logical or empirical basis for this assumption is offered. The Department of Justice has been investigating joint venture pipelines continuously for decades. No such conspiracy has ever been detected. NERA assumes that they are not only occurring every day throughout the nation but that they are perfect conspiracies, something economists have thus far never observed.

The upshot of all these systematic biases toward finding concentration and monopoly power is that their true presence must be overestimated many times. Indeed, several of these biases alone could raise estimated concentration and monopoly power several-fold.

We conclude that the NERA report, primarily because of its unrealistic approach, does not offer a valid basis for judging competition in the oil pipeline industry.

II. The NERA Approach

The principal conclusion of the NERA study is that "*competition is ineffective in many oil pipeline markets. In the absence of regulation, many, if not most, oil pipelines would have substantial market power and would be able to charge high rates and earn substantial monopoly profits*."[3] (Their italics.)

This conclusion is based not on observation of what rates have been charged or what profits have actually been earned, but solely on computations of "concentration" in certain markets said to be "randomly" selected.[4] We do not know the random sampling procedure that selected these markets; it is not described in the NERA study. The computations that give rise to the NERA conclusion were not made available although requests have been made to the authors for copies of all working papers. (Copies of working papers of my study had been made available to NERA prior to commencement of their study.) All that we have is a general description of the NERA methodology and a summary of the statistical conclusions.

To conclude that "many, if not most, oil pipelines would have substantial market power and would be able to charge high rates and earn substantial monopoly profits" requires first, that there be a strong connection between concentration as NERA defines it and substantial market power, high prices (or rates) and monopoly profits, second, that the level of concentration assigned to oil pipelines by the NERA study be great enough to imply a lack of competition, substantial market power and monopoly profits; and third, that the NERA estimate of concentration be correct.

---

[3] Op. cit., p. 14.

[4] Crude production centers and product markets were selected in this way. Refinery markets used by NERA were taken from my study. See Mitchell, op. cit., pp. 79-85.

The last is mainly a question of fact that we will consider extensively in Section V and conclude that NERA is far off the mark exaggerating the degree of concentration by a multiple of its true value. The first two requirements are matters of judgment where subjectivity plays a role and where reasonable researchers and policy makers may differ. Economists vary greatly in their views on the ability of concentration to imply monopoly power. Many believe the connection is strong. Others believe the correlation is weak or non-existent. Some believe it exists but is spurious, that is, explained as well by theories not involving market power.[5]

The NERA authors admit that their view is controversial. Specifically, they concede that there is "some controversy" about the ability to explain or predict competitiveness by looking at concentration "*alone*"[6] (their italics). The NERA authors obviously place themselves toward one end of the spectrum of economic views.

---

[5] There is a vast literature of the concentration theory. One useful survey of views is Goldschmid, Mann and Weston, Industrial Concentration: The New Learning, Boston (1974). See also R. Mancke, "Interfirm Profitability Differences," Quarterly Journal of Economics (May 1974) for a simple non-market power interpretation of the data.

[6] Ibid., p. 41.

Given this assumed validity of the "concentration doctrine" how great must concentration be to make an industry "uncompetitive"? The NERA authors characterize a pipeline market as "uncompetitive" if they compute an H-H index of 2,500 or higher.[7] Such a figure could result from:

(a) four equal sized firms;

(b) one firm with half the market and many very small firms;

(c) two firms, each with 35.36 percent of the market, and many very small firms;

(d) three firms, each with 28.87 percent of the market, and many very small firms;

and of course an infinite variety of possibilities in between.

A more conventional measure of concentration is the four-firm concentration ratio, which is the percentage of the market represented by the four largest firms. For the examples above of an H-H of 2,500 the four-firm concentration ratios would be:

(a) 100.0
(b) 50.0
(c) 70.7
(d) 86.6

---

[7] At NERA, op. cit., p. 97, the section B caption is *Half of the Markets are Uncompetitive*, referring to markets with *H-H indexes of 2,500 or higher.* An H-H index is computed by adding the sums of the squares of the market share percentages of each firm.

John Blair, former Chief Economist of the Senate's Subcommittee on Antitrust and Monopoly and a supporter of the concentration doctrine, estimated that about 40 percent of all the 1963 manufacturing output in the United States was produced in industries with concentration ratios 50 percent or higher.[8] Many major industries have had concentration ratios of 80 percent or higher: computers, telephone equipment, automobiles, heavy electrical equipment, drugs, photographic film, copying equipment, industrial chemicals, soaps and detergents, aircraft and engines, cereals, and locomotives. Not one of these industries is regulated.

If the concentration doctrine were substantially correct and the benefits of regulation would exceed the costs, regulation of oligopolies like those cited above might be justified. But the Congress of the United States has never accepted this argument nor its underlying assumptions. It has been the economic and industrial policy of the United States to deal with concentrated oligopolies through antitrust policy, not price regulation.

In the context of a debate as to whether oil pipelines should be regulated or unregulated the terms "competitive" and "uncompetitive" take on specific meanings. We are concerned with whether the pipeline industry or particular markets that industry serves are sufficiently competitive to be unregulated or sufficiently uncompetitive to be regulated. In this context NERA's use of the word "uncompetitive" has a clear implication. That markets with degrees of concentration similar to what NERA incorrectly assigns to some oil pipeline markets are commonplace in American industry and are not regulated suggests that NERA's use of the term "uncompetitive" is extreme and inappropriate in the context of a regulation-deregulation debate.[9]

---

[8] J.M. Blair, Economic Concentration, New York (1972), p. 14.

---

[9] The counterargument that oil pipelines are already regulated and therefore subject to a burden of proof to become deregulated fails because rate regulation as economists understand the term has never existed in the oil pipeline industry. See Mitchell, op. cit., pp. 40-56 and below.

III. The Issue of Profitability

There are five studies that I know of bearing upon the question of whether the profitability of oil pipelines is normal and therefore consistent with competition:

(1) The work of Rodney Harrill and Exxon, especially his testimony in the Williams case;[10]

(2) the work of Gerald Pogue of New York University, in particular his testimony in the Williams case;[11]

(3) the study of L. Douglas Smith of the University of Missouri presented as testimony in the Williams case;[12]

(4) the dissertation of John Hansen;[13] and

(5) the article by Thomas Spavins of the Department of Justice in my volume Oil Pipelines and Public Policy.[14]

My section IIIA in A Study of Oil Pipeline Competition deals with this profitability issue by showing that comparisons of profitability between industries for purposes of determining whether monopoly profits might exist require that profitability of each industry be related to or adjusted for financial and business risk. A simple arithmetic example is given showing that firms with the same prices and costs in the same market can earn appreciably different rates of return if they are financed differently. These differences in profitability attributable to financial structure can therefore have no bearing on the existence or nonexistence of monopoly power. This would be an especially important point in measuring profits of oil pipelines since the Elkins Act Consent Decree had induced an extreme debt-oriented financial structure on the oil pipeline industry.

---

[10] Verified Statement of Rodney Harrill, Federal Energy Regulatory Commission, Williams Pipe Line Company Proceeding, Docket Nos. OR-79-1, et. al. hereafter referred to as Williams Proceedings.

[11] Verified Statement of Gerald Pogue, Williams Proceedings.

[12] Testimony of L. Douglas Smith, Williams Proceedings.

[13] J. Hansen, Competitive Aspects of United States Petroleum Pipeline Industry: Implications for Regulatory Policy, Ph.D. Dissertation, Yale University (1980).

[14] T. Spavins, "The Regulation of Oil Pipelines," in E. Mitchell, ed. Oil Pipelines and Publc Policy, American Enterprise Institute, Washington, D.C. (1979).

The only studies adjusting for financial and business risk are those of Harrill, Pogue and Smith.[15] All find oil pipeline profitability about normal when adjusted for these risks. The Hansen and Spavins studies do not consider financial risk and pay only minor attention to business risk. They were therefore ignored in my report.

The NERA report cites only three analyses of profitability: Hansen, Spavins and mine. The NERA report argues:

(1) Spavins finds somewhat high rates of return for oil pipelines but does not infer monopoly power;

(2) Hansen finds significantly higher rates of return for oil pipelines;[16]

---

[15] The Smith study was not mentioned in my report since I was unfamiliar with it at that time.

[16] The Hansen oil pipeline profitability figures were ambiguous on the matter of whether they were de-levered or not. However, his gas pipeline data were not de-levered and Hansen claims they are comparable to the oil pipeline statistics. Thus, we infer that the oil pipeline profits were not delevered. See Hansen, op. cit., pp. 146-149.

(3) Mitchell concludes oil pipelines earn normal rates of return;

(4) Mitchell assumes oil pipelines have average risk;

(5) All studies are based on "weak and incomplete data" leading to ambiguous conflicting interpretations."

(6) Inferences from the profitability data are therefore speculative and inconclusive.

The NERA characterization of the debate is extremely misleading. First, the Hansen and Spavins studies are just plain wrong in not adjusting for financial risk. And their error does not involve some fine point of financial theory. The Hansen and Spavins fallacy has been discussed in freshman and sophomore accounting texts for more than a decade.[17]

That Spavins had not taken into account financial risk was pointed out by Shyam Sunder a discussant of the Spavins paper at the conference at which it was given. Sunder's remarks were reprinted in the proceedings volume following the Spavins article.[18]

Second, I did not assume anything about risk in the oil pipeline industry. My conclusions about risk were supported by the only two systematic studies about risk I was aware of. A third study I was not aware of , that of L. Douglas Smith, also supports my conclusion.

---

[17] See, for example, Salmanson, Hermanson and Edwards, A Survey of Basic Accounting (1973), pp. 192-93, and Spiller, Financial Accounting (1977), pp. 653-656.

[18] Mitchell, Oil Pipelines..., pp. 113-116. Sunder also criticized the lack of adjustment for business risk in both the Spavins and Exxon presentations. The Exxon paper as presented subsequently by Harrill in the Williams case did assess business risk, thus eliminating this deficiency.

Third, referring to the profit data as "weak and incomplete" is an extraordinary step on the part of NERA. Data on profitability for the oil pipeline industry are in quality a cut above data for most U.S. industries because of ICC/FERC requirements to carefully segregate pipeline operations data from other data and to develop data on replacement cost. If these data are inadequate for profitability comparisons then a fortiori comparison among other industries are impossible. If so, the whole concentration theory goes out the window. For the sole basis of the concentration theory is an empirical correlation between concentration and these same profitability data. If the concentration theory is gone so is the NERA structural analysis of markets which is based entirely on this theory.

What NERA has done on the profitability issue is to throw up a smokescreen. The NERA authors avoid rebutting the standard practices of financial analysis and my application of them to this issue. By extensively citing two earlier studies whose methodology was shown to be wrong in my report, and by ignoring the only sophisticated studies of the question, the reader is given the impression that it is all ambiguous and inconclusive. On the contrary, all the properly done studies reach the same conclusion: the oil pipeline industry is about average in risk and profitability.

A second profit related issue is whether ICC or Elkins Act Consent Decree restrictions held oil pipeline profits down. NERA notes that with regard to the ICC restrictions that Hansen says they are binding, Mitchell says they aren't, and therefore it's all inconclusive again. There is no comment from NERA on the details of each analysis. Let me indicate the differences:

(1) Hansen uses beginning of the year ICC valuation as the rate base. This is wrong; it should be end of year. Thus, Hansen's basic numbers are wrong.

(2) Hansen uses a single year (1977), while I use an average of 5 years (1975-1979);

(3) Hansen lumps all pipelines together when in fact some are subject to an 8% guideline or ceiling, others 10%, and others a mixture of the two. My analysis calculates the guideline rate for each individual company.

(4) Hansen uses a five percentage point wide interval for plotting the data, that is, 5 percent to 10 percent, 10 percent to 15 percent, etc. Since the overwhelming bulk of the observations fall between 5 and 15 percent and the average is significantly less than 10, it is hardly surprising that most observations fall in the class under 10 percent.[19] I use a one percent interval and find no tendency for the data to pile up at the ceiling or guideline level.[20]

---

[19] Hansen, op. cit., pp. 143-146.

[20] Mitchell, op. cit., pp. 40-46.

Hansen does not analyze the possible effects of the consent decree in restricting profits. I found it generally unrestrictive but possibly restrictive in a few cases.[21] One of the NERA authors, in a separate publication, argues that the consent decree was not restrictive.[22]

After my study was completed the consent decree was vacated and at approximately the same time the FERC dropped the 8 and 10 percent guidelines. Thus, neither constraint has been in effect during 1983. An experiment of sorts is therefore being carried out this year. If the decree and the guidelines were serious constraints, pipeline rates should be popping up all over the place. While the hard data are not in hand, casual evidence suggests no dramatic rate response.

Although written after these events the NERA report does not comment on any of this.

---

[21] Ibid., pp. 47-56.

[22] R.E. Anderson, "Oil Pipeline Regulation: The U.S. Experience," in R.N. Morrison and R.J. Schultz, eds., Pipeline Regulation and Inflation, Montreal, McGill University, 1983, pp. 99-100.

IV. Competition from Water Transport

The test of whether water transport and pipelines compete in moving oil is whether shippers in a particular situation actually choose both modes. For example, if a refiner wishes to move oil from his refinery and ships some by pipeline and some by barge, the pipeline companies and the barge companies would have to be regarded as competitors. This is true regardless of whether the pipelines and barges all go to the same place. In general, they don't. But a reduction in the rate charged by one transport company will generally attract business away from the others by making the delivered cost, wherever the oil is going, cheaper. The same point obviously applies to all oil arriving at the same point by different transport companies, regardless of where the oil originated. In cases where oil is always shipped out or in by only one mode, pipeline or barge or tanker, then it has to be said that the alternative modes do not presently compete (although there may be the potential for competition).

In my study it was concluded that water transport is very commonly in competition with pipelines. This was deduced from the following facts: (1) the vast majority of consuming, producing and refinery centers are on or near waterways; (2) more than forty percent of movement of oil within the U.S. (by ton-mile) is by water; (3) a much larger volume than that arrives by water transport from overseas; and (4) my study of individual "worst case" markets found significant volumes of product or crude entered or left a market in competition with pipelines. For example, of the 14 consumer markets served by a single pipeline we found that 11 had access to water transport and 9 of these had receipts of gasoline in excess of 43 percent of local consumption.

Another way of looking at water versus pipeline transport is to compare costs or rates per mile. This approach has serious problems. First, the pipelines, barges and tankers entering or leaving a market are in general not going to or coming from the same place. What then is the significance of their various rates per mile? If we agree, as the NERA authors and I do, that the analysis of origin and destination markets is a more reasonable approach than the analysis of corridor competition, then why analyze water versus pipeline costs on a per mile or implicitly corridor basis?

Second, rates per barrel for a given corridor do not seem to be decisive or even dominant even in the shipper's choice between pipelines. Service differences appear to be substantial and examples are given in my study of significant service differences including a major case[23] where the much higher priced pipeline is the one overwhelmingly chosen by non-owner shippers. If we cannot use rates as a measure of the competitiveness of two very similar pipelines in the same corridor, how can we use them to compare pipelines and water transport with different origins or destinations?

---

[23] Mitchell, op. cit., pp. 11-12.

My discussion of comparative rates in my "study" consisted of a single skeptical paragraph:

> The costs of moving oil by tanker and barge appear to be in the same broad range as the cost of movement by pipeline. We have already indicated that pipeline rates cannot readily be compared to one another because of substantial differences in service. This point holds with even greater force when comparing water transport rates to pipeline rates. Nevertheless, we have computed average revenues per 100 barrel-miles for 17 product pipelines, and barge rates per 100 barrel-miles for a sample of 81 barge hauls of gasoline, jet fuel, kerosene and distillate.* The range of pipeline costs was 4.4 to 23.2 cents; the range of barge costs was 2.2 to 31.9 cents. The average pipeline cost was 14.2 cents; the average barge cost was 8.9 cents. Considering that pipelines will generally offer more terminalling service and will usually have faster delivery times, the costs of the competing modes seem to be in the same ball park. But it is a very large ball park, reinforcing our point that service differences make detailed comparisons impossible. Tanker costs should generally be less than barge costs, and hence also competitive with pipelines.[24]

The NERA report places great emphasis on relative costs in spite of their doubtful relevance. Using essentially the same data on pipeline and barge costs they come up with a radically different conclusion: barges can't compete with pipelines. Since NERA did not provide its working papers there is no way to check their calculations or precise methodology. Nevertheless, even taking their computations at face value it is easy to see why they come up with the conclusions they do.

---

*The pipeline revenues and barrel miles were obtained from the Oil and Gas Journal (Aug. 11, 1980 issue, pp. 82-86), which in turn obtained them from the ICC Form Ps. The barge rate data were obtained from the Barge Line-Haul Rate Study performed by the Navigation Analysis Center, Corps of Engineers, Fort Belvoir, Virginia. These data were confidentially collected from barge companies. Both sets of data are for the year 1979. Barge rates were inflated by a factor of 1.33 to allow for the fact that barges must typically travel about one-third greater distance to reach the same destination due to the indirectness of rivers.

[24] Ibid., pp. 19-20.

One objection to my calculations by NERA is that the circuitousness of water transport is greater than the 30 percent I used in my report. NERA wants 50 percent. Obviously, using 50 percent instead of 30 percent to arrive at the figures in my paragraph quoted above would change none of the conclusions.

NERA's argument on comparative costs is based on three tables and one figure reproduced here: Table IV-5, IV-6, IV-7 and Figure IV-1. Table IV-5 shows what is well known to anyone with passing acquaintance of the pipeline industry: certain large diameter, large volume pipelines have very low rates per mile as compared to the vast number of pipelines and ship a very large percentage of all oil moved by pipeline in the United States. Indeed, one pipeline, Colonial, accounts for 33 percent of the total barrel-miles in Table IV-5, while another, Lakehead, would account for over 18 percent.[25]

There are two ways to look at "representative" pipeline rates. One is to weight by barrel-miles. In this case pipelines like Colonial and Lakehead dominate the statistics even though their shipments go mainly to only a few of the numerous markets covered by my study or by the NERA report.

---

[25] The NERA authors do not reveal which pipelines are included in Table IV-5. Nearly half the pipelines listed in their source are excluded. Colonial is in; they say so. Lakehead may or may not be.

Table IV-5

Pipeline Shipment Shares by Average Revenue 1979

Average Revenue Per 100 Barrel-Miles (Cents)	Pipeline Companies[a/]		Shipments	
	Number (1)	Share of Total (Percent) (2)	Barrel-Miles (Billions) (3)	Share of Total (Percent) (4)
2.6 to 5.0¢	8	11.9%	1,340.0	64.1%
5.1 to 7.5	7	10.4	252.6	12.1
7.6 to 10.0	6	9.0	59.4	2.8
10.1 to 12.5	7	10.4	124.0	5.9
12.6 to 15.0	4	6.0	47.7	2.3
15.1 to 17.5	9	13.4	182.5	8.7
17.6 to 20.0	5	7.5	23.2	1.1
20.1 to 22.5	1	1.5	29.2	1.4
22.6 to 25.0	3	4.5	25.0	1.2
Over 25.0	17	25.4	6.1	0.3
Total	67	100.0%	2,089.7	100.0%

Note: Detail may not add to total due to rounding.

[a/] Includes companies which have only trunkline transportation.

Source: Oil and Gas Journal, August 11, 1980, Vol. 78, No. 32, pp. 82-86. Data are collected from Form P filed with the Federal Energy Regulatory Commission.

Another way is to look at a typical or median pipeline. In Table IV-5 the median pipeline with respect to rates would be 33rd or 34th of the 67 pipelines covered. This would fall in the 15.1 to 17.5 cents per 100 barrel-mile range.

If we use the rate figures based on the average barrel-mile, then we must recognize that we are dealing essentially with barrels moved into the Washington, D.C.-New York City corridor, or the Chicago market. If we use the typical or median pipeline rates then we are dealing with barrels moved into or out of markets throughout the country including those very small markets emphasized in the NERA structural analysis.

If we use the big-market, big-pipeline approach, it is clear that barges are not apt to be significant competitors on a parallel or corridor basis. This is what the NERA analysis supports. The Colonial Pipe Line competes with the huge refinery complexes along the east coast which are supplied with foreign crude oil delivered by ocean-going tankers. As detailed in my study, these alternative sources dominate the Colonial Pipe Line in the areas where it delivers at these very low rates, Colonial tariffs being determined by equating the delivered cost of Gulf Coast product to the east coast cargo prices set by freely entering foreign crude and product.[26] Similarly, in

---

[26] It was pointed out in my study that Colonial's entire capacity from North Carolina to New York is less than a third of product imports and refinery capacity in the New York-Philadelphia area alone. References there also document the fact that Colonial's rates equate with New York area prices, not the small shipments from the Gulf Coast.

Chicago thirteen crude and product pipelines, including several large diameter lines, such as Explorer (24"), Lakehead (34"), ARCO (22"), and Amoco (22"), deliver to the market. Again, there is plenty of competition with or without barge transport.

The issue of barge competition therefore arises primarily in places other than these big-market, big-pipeline situations and the relevant pipeline rates are therefore those of the typical pipeline. Turning to Table IV-6 we note that the only rates that fall within the median class of rates (15 to 17.5 cents per 100-barrel-miles) are those corresponding to a 25,000 b/d pipeline with a 100 mile haul and a 10,000 b/d pipeline with a 200 mile haul. All figures in this table to the left and above these figures (which are circled) represent pipelines with rates above the median. There is one such number. All figures in this table to the right and below these figures represent pipelines with rates below the median pipeline. There are 117 of these. The table thus presents an array of rates corresponding almost exclusively to the big pipeline, big market situation.

Moving to Figure IV-1, I have circled all those pipeline rates in the figure that would be contained in the median rate class. All other rates shown are below the median. None shown are above the median. Again, the figure represents almost exclusively unusually low rates.

Finally using the data in Table IV-7 I have constructed Table 1 comparing barge rates for gasoline and kerosene with pipeline rates in the median class.

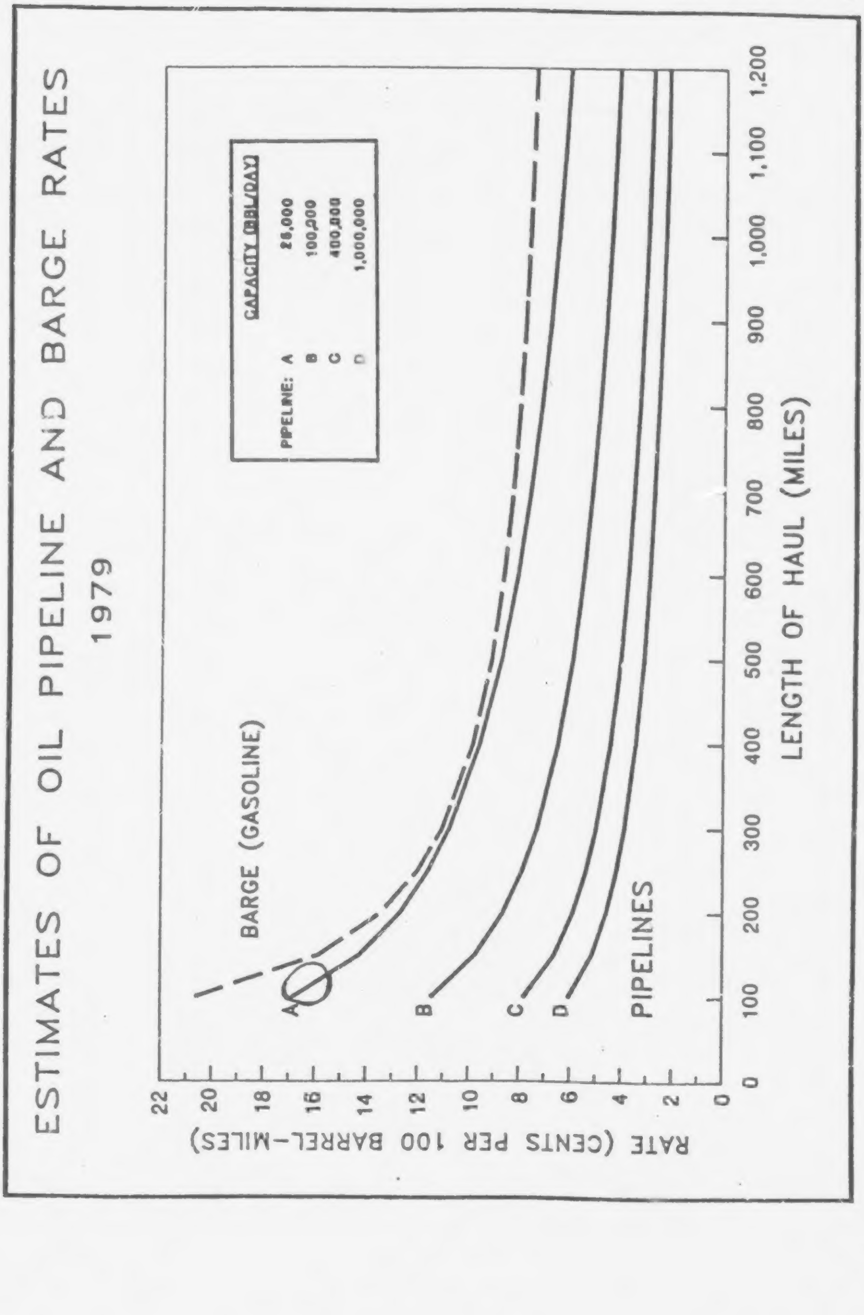
NERA **Table IV-6**

Calculation of Oil Pipeline Rates
1979

Length of Haul (Miles)	Capacity (1,000 Barrels Per Day)									
	10	25	50	100	200	400	600	800	1,000	1,200
	(Cents Per 100 Barrel-Miles)									
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
100	21.7 ¢	16.8 ¢	13.9 ¢	11.5 ¢	9.4 ¢	7.8 ¢	7.0 ¢	6.4 ¢	6.0 ¢	5.8 ¢
200	16.3	12.7	10.5	8.6	7.1	5.9	5.2	4.8	4.6	4.3
300	13.8	10.7	8.9	7.3	6.0	5.0	4.4	4.1	3.9	3.7
400	12.3	9.6	7.9	6.5	5.4	4.4	4.0	3.6	3.4	3.3
500	11.2	8.7	7.2	5.9	4.9	4.0	3.6	3.3	3.1	3.0
600	10.4	8.1	6.7	5.5	4.6	3.8	3.4	3.1	2.9	2.8
700	9.8	7.6	6.3	5.2	4.3	3.5	3.2	2.9	2.7	2.6
800	9.3	7.2	5.9	4.9	4.0	3.3	3.0	2.8	2.6	2.5
900	8.8	6.9	5.7	4.7	3.8	3.2	2.8	2.6	2.5	2.3
1,000	8.5	6.6	5.4	4.5	3.7	3.0	2.7	2.5	2.4	2.2
1,100	8.1	6.3	5.2	4.3	3.6	2.9	2.6	2.4	2.3	2.2
1,200	7.9	6.1	5.0	4.2	3.4	2.8	2.5	2.3	2.2	2.1

Source: Derived from a regression equation estimated from capacity and length data gathered by the U.S. Department of Energy through the form U.S. Petroleum Pipeline Sizing Survey, EIA-184 (11-79) and rate data in tariffs filed with the FERC as published in Pipe Line Rates on Crude Petroleum Oil (Kensington, Maryland: CSG Press), October 29, 1982; and Pipe Line Rates on Gasoline and Petroleum Products (Kensington, Maryland: CSG Press), October 29, 1982.

NERA FIGURE IV-1



ESTIMATES OF OIL PIPELINE AND BARGE RATES
1979

NERA

NERA **Table IV-7**

Estimates of Barge Rates[a]
1979

Length of Haul (Miles)	Crude Oil (Cents Per 100 Barrel-Miles) (1)	Gasoline/ Kerosene (Cents Per 100 Barrel-Miles) (2)	Distillate Fuel Oil (Cents Per 100 Barrel-Miles) (3)
100	20.3¢	20.6¢	19.8¢
200	14.6	13.4	15.0
300	12.7	11.0	13.4
400	11.8	9.8	12.6
500	11.2	9.1	12.1
600	10.8	8.6	11.8
700	10.6	8.3	11.6
800	10.4	8.0	11.4
900	10.2	7.8	11.3
1,000	10.1	7.7	11.2
1,100	10.0	7.5	11.1
1,200	9.9	7.4	11.0

[a] The original U. S. Army Corps of Engineers estimates were increased by NERA by 50 percent to reflect the greater length of a water route compared to a pipeline route. The rates were converted from tons to barrels assuming 6.50 barrels per ton of crude, 7.30 barrels per ton of gasoline/kerosene and 6.58 barrels per ton of distillate.

Source: U. S. Army Corps of Engineers, Institute of Water Resources, Navigation Analysis Center, "Barge Line-Haul Rate Study: Regression Analysis," December 1981.

Table 1

Revenues per 100 Barrel Miles
(in cents)

Length of Haul (Miles)	10,000 bpd Pipeline	25,000 bpd Pipeline	Barge (Gasoline/kerosene)
100	--	16.8	20.6
200	16.3	--	13.4

In one case the pipeline is a few cents cheaper; in the other case the barge is a few cents cheaper. If we take the only number in Table IV-6 representing a pipeline with higher than typical costs -- the 21.7 cents for a 10,000 bpd pipeline with a 100 mile haul -- it is found to be more costly than any barge haul given. Indeed, one could readily construct a table like IV-6 and a diagram like IV-1 that displayed pipeline costs always above barge costs by restricting the figures to above median cost pipelines.

The NERA tables and figures would like to lead us to the conclusion that barges can't compete with pipelines. What they show instead is that low cost pipelines have lower costs than high cost pipelines and average cost barges -- hardly a profound demonstration.

It is easy to see that there is something seriously wrong with the NERA figures and arguments. For they not only "prove" that barges can't compete with large-scale pipelines, but also that the vast majority of pipelines can't compete with the few large-scale lines. Efficient oil transport is reduced to just giant pipelines.

The first problem with this conclusion is that the vast majority of markets recognized in NERA's study and mine are served by neither, as even casual observation of a pipeline map would show. In most markets volumes just cannot justify large scale lines. (Indeed, in some of the small NERA markets volumes cannot justify any pipeline at all.) The second problem is that smaller pipelines and barges often deliver and collect in competition with large lines. Sometimes they do not parallel large-scale lines. They go to or come from different places. Or, they may run parallel but offer significantly different services, a factor that cannot be captured in revenue per barrel-mile data.

The NERA authors, having banished barges and non-giant pipelines from competitive existence, then attempt to show that water transport actually moves very little oil. But the overall statistics on this matter are very clear. NERA's own Table IV-1 shows water transport accounting for more ton-miles than pipeline transport in 1980 -- 50 percent versus 47 percent of the total amount moved.[27] And this is only domestic movement. Oil coming into the U.S. Gulf Coast and East Coast are not counted in these statistics although they present just as much competition. For example, oil products moving from Caribbean refineries to the

---

[27] A valid NERA point is that while barges and tankers can move heavy fuel oil, pipelines generally cannot. Therefore, a careful analysis would exclude these shipments. In my detailed analysis of markets I have always done this. As far as the aggregate statistics are concerned, domestic heavy fuel oil represents only about 10 percent of refining output and so the aggregates would not be much affected if we could adjust them.

U.S. east coast move in low-cost foreign tankers and compete directly with product moved from U.S. Gulf Coast refineries to the East Coast by Colonial.

Subsequent NERA tables attempt to make water transport of oil disappear by simply eliminating areas where water transport is more pronounced. Thus, Table IV-2 excludes the West Coast because too much water-borne Alaskan crude lands there, while Table IV-3 points out that water borne shipments of petroleum products from PAD District I to Districts II and III show smaller percentages of water shipment than the national statistics.

But this is a hopeless exercise. If water shipments in some defined areas are below the national percentages this only points up that the remaining areas are above the national percentages. No one has argued that water shipments are distributed evenly throughout the nation. What are we to infer from this device? That Alaska and the West Coast don't count? That movements between certain PAD Districts are more important than movements within districts, or movements from outside the U.S., or movements between other districts?

The relevant question to the issue of competition and regulation is whether water transport is actually a significant competitive force in markets where there is abnormally low pipeline competition. In my study a number of specific markets, which I referred to as "worst cases," were examined for water competition. These were not PAD Districts, which encompass ten states on average, but specific cities, refining centers, and producing centers. In markets where water transport was possible the typical role of water transport was large. For example, in the 11 "worst-case" consumer markets water shipments of gasoline averaged 86 percent of estimated local consumption.

The degree of water transport competition varies greatly from place to place and only analyses of specific markets are apt to tell us much about its competitive role. With NERA's emphasis on very small markets (counties, BEA economic areas) it is startling to see the whole water competition discussion at its most disaggregative level run in terms of PAD Districts which average ten states in size. It is further surprising in view of the fact that the data on water deliveries of crude and product are the only complete set of such data available on a market basis each year. Nothing of this quality is available on pipelines or refineries. When we do examine data at the specific market level they show a large competitive role for water transport.

V. The Structural Analysis

The centerpiece of the NERA report is its assessment of the degree of concentration in oil pipeline markets. In my report concentration measures were not estimated because precise estimates of concentration require data that are either unavailable or nonexistent, and strong assumptions must be made instead. The assumptions made by NERA are so unrealistic, inconsistent with their own positions, and so biased toward finding concentration where it doesn't exist as to make their calculations meaningless.

A limited survey of NERA's methodological errors follows.

* * * * *

(1) NERA does not actually calculate water shipments into or out of any of the markets covered. Yet these are the only data related to concentration actually available. For oil pipelines and refineries they use estimated capacity figures because actual shipments and refinery outputs are not available. NERA handles water transport by placing all markets with HHI 2,500 or higher with access to water transport in a medium risk category, which they define to be "uncompetitive." Thus, if 90% of the shipments into or out of a market were by water and 4 pipelines shared equally the remaining 10% of the market, the pipelines would be deemed to have market power and capable of achieving monopoly prices and profits since the HHI of the pipelines alone would be 2,500.

A reasonable assessment of this hypothetical case is that the pipelines each have only 2.5% of the market, that the remaining water transport represents an atomistic structure itself, and that therefore the market is best characterized as being atomistic, the oil pipelines having essentially no market power.

We have already seen that in markets where a single pipeline delivers, water shipments tend to be very large -- 86% of local consumption on average. Thus, situations like the hypothetical one described above are apt to be common and NERA would therefore often be classifying as uncompetitive markets that are very unconcentrated.

* * * * *

(2) Except in cases where local consumption exceeds local refinery capacity and the refining center is located in an SMSA, local consumption is not considered as an outlet for local refineries. In other words, in Minneapolis, where NERA estimates local consumption to be 87% of refining capacity NERA deems the Williams pipeline to be a monopoly because it is the only products pipeline collecting in Minneapolis. Minneapolis thus falls into the high risk category and is an uncompetitive product collection market.

The realities are as follows:

(a) In recent years refineries uncommonly operate at rates as high as 87% of capacity. Thus, actual refinery output is likely to be less than local consumption.

(b) Some product leaves Minneapolis by water.

(c) Some product leaves on Koch's private line -- Koch is one of the two refiners in Minneapolis -- and goes generally to the same area as Williams.

(d) This means that the share of the Minneapolis refinery output taken by Williams is apt to be something less than 10%, perhaps less than 5%. (In my study I estimated Williams' share of Minneapolis refinery output plus Williams deliveries into Minneapolis to be 16.7%. Much of this would of course be product mainly passing through Minneapolis and not originating there.)

Thus, a pipeline that has a relatively small share of the market winds up being classified by NERA as a monopolist, uncompetitive, and high risk.

NERA's rationale for their approach is extraordinary.[28] I quote:

"For some of the other single pipeline markets, Mitchell argues the pipeline collects only a small percentage of the products refined in that market. The rest is either consumed locally or shipped out by water transportation. Even so, there is no compelling reason why the single pipeline could not substantially increase its rates in the absence of regulation without fear of reduced throughput. For example, if there were no excess demand at prevailing prices in the local market, shifting sales to the local market could result in even lower prices and profits for the refiner than paying the pipeline a higher rate."

---

[28] NERA, op. cit., p. 118.

In other words, if there were 100 equal sized sellers in a market and if all buyers cannot acquire all they want to buy at some particular price from 99 of them, the remaining seller has monopoly power. This is simply wrong. The single pipeline in the quote above can increase its rates but it will lose throughput. NERA is implicitly arguing that individual sellers in the marketplace face vertical demand curves, a view in conflict with all economic theory and practice. Furthermore, if NERA believes this they should not worry about concentration; all buyers and sellers would have infinite monopoly power regardless of the level of concentration if their argument were correct.

* * * * *

(3) No adjustment is made when the shipper and the pipeline owner are vertically integrated. Thus, Amoco being the only crude pipeline company shipping into Mandan, North Dakota would be classified a monopoly, uncompetitive and high risk in NERA's Figure I-1 on p. 12. The fact that the only shipper of crude on this line is Amoco itself, since the only refinery in Mandan is an Amoco refinery, does not affect NERA's calculations.

On p. 109 NERA concedes that no harm can be done by this monopolist since the only entity it can exploit is itself. NERA also emphasizes the fact most oil pipelines are owned by oil companies, indeed, that the 18 largest oil companies move 80 percent of all the crude and product moved by pipeline (pp. 19, 36).

Our best guess is that about three quarters of all oil moved through pipelines is owned by the pipeline owner. Since the shipper cannot be harmed in this situation this implies that three quarters of the barrels moved present no market power or monopoly problem regardless of the concentration in the market. An appropriate adjustment therefore for all the concentration figures would be to remove all barrels moved by shipper-owners from the uncompetitive class. Since concentration is significantly correlated with vertical integration -- in my study 6 of the 11 crude delivery markets with a single pipeline were 100% vertically integrated -- this probably means removing appreciably more than three quarters of the volumes from "uncompetitive" markets.

* * * * *

(4) NERA measures concentration in product markets by estimating the capacity of oil pipelines and refineries serving the market and using these statistics to compute concentration. Thus, if there are two refineries each with 50,000 bpd capacity and one pipeline delivering product, with 50,000 bpd throughput capacity, the market would consist of 3 entities each with a 1/3 market share. This would yield an HHI index of 3,333 and a 4-firm concentration ratio of 100 and would be classified as "uncompetitive" by NERA.

This approach involves a serious mistake. While refinery capacity does give an indication of sales of a local refiner throughput capacity does not give any reckoning of what a pipeline delivers to the local market. A 50,000 bpd capacity pipeline starting at A with delivery points at B, C, D, and E, terminating at F cannot deliver 50,000 bpd to B, C, D, E, and F unless it also collects 50,000 bpd at B, C, D, and E. Yet, a pipeline that delivered its full capacity, then collected its full capacity, at each delivery point would be a rarity, and probably has never existed. At the other extreme, if a pipeline collected only at its origin, the pipeline volume estimated by NERA would be overstated by a multiple equal to the number of delivery points. Since the latter extreme is typically closer to reality than the former, the pipeline share of the market as estimated by NERA must be greatly overstated.

For simplicity's sake take a pipeline with few terminals like Explorer. It's capacity and throughput in barrels per day in 1979 were as follows:[29]

Distance	Segment	Capacity	Throughput
524 Mi.	Houston, Tx, to Glenpool, Ok (Tulsa)	380,000 bpd	233,000 bpd
403 Mi.	Glenpool, Ok (Tulsa) to Wood River, Il. (St. Louis)	290,000	113,000
249 Mi.	Wood River, Il. (St. Louis) to Hammond, Ind. (Chicago)	290,000	47,000

---

[29] All data were derived from the Department of Energy's U.S. petroleum pipeline sizing survey. Explorer Pipeline Company informs me that collections at each of the terminals analyzed here were generally less than ten percent of deliveries, making the "net delivery" figures here approximately equal to actual deliveries.

The net deliveries (deliveries minus collections) to each terminal and their percentage of capacity would be as follows:

Tulsa	120,000 bpd	31.6%
St. Louis	66,000 bpd	22.8
Chicago	47,000 bpd	16.2

These results do not primarily come from the fact that Explorer operated at a low level of utilization in 1979. In 1977, when Explorer operated at its highest level of utilization the statistics were as follows:

Segment	Utilization Level	Net Deliveries ÷ Capacity
Houston to Tulsa	71%	14.5%
Tulsa to St. Louis	90	26.9
St. Louis to Chicago	66	47.9

On average, capacity figures overstated net deliveries by a little over three-fold corresponding to the three terminals. Since pipelines will typically have more than three terminals the overstatement of pipeline deliveries is likely to be greater.

A second bias in the NERA approach is that a larger pipeline is most likely to continue on to further destinations. Generally speaking, large scale pipelines are longer. This means that at any given terminal the smaller pipeline is more likely to be delivering a larger fraction of its capacity than a larger pipeline since the smaller pipeline is more likely to be terminating. For example, the Arco 8" line and Continental's 2-10" lines end at St. Louis, while the largest line, the Explorer 24" line, continues to Chicago. Estimating deliveries by capacity will therefore inflate the contribution of the larger lines and thus increase estimated concentration among the pipelines.

* * * * *

(5) NERA ignores half of each market that it studies, namely, the shipper half. Market power of a buyer over a seller, or vice-versa, cannot be analyzed by looking at just the buyer's or just the seller's side. Thus, if two pipelines deliver crude to, or collect product from, a single refinery it makes no sense to compute concentration on the pipeline side and ignore the refiner side. NERA would in this case assign a concentration ratio and HHI inevitably leading the pipelines to be classified as uncompetitive and therefore candidates for regulation. Yet concentration is higher on the refiner side and a reasonable observer would conclude that it was the refiner that had the market power and that if the pipeline's rates deviated from the competitive level it would more likely be on the downside.

How common is it that refiner concentration is greater than pipeline concentration? As noted above there are no data on refinery output and incomplete data on pipeline delivery and so we are reduced to counting refineries and pipelines rather than comparing their deliveries or collections. To put pipelines on a similar footing with refiners we eliminate refining centers with direct access to water transport since otherwise counting pipelines would understate competition as compared to counting refineries.

This still overestimates the market power of pipelines since local consumption and sources are not considered. For example, in Bakersfield, a market where refiners greatly outnumber pipelines, pipelines collect product equal only to 10 percent of the refinery capacity.

In my report, Table IV.6, pp. 80-81, there are 20 refining centers without direct access to water transport. Looking at the crude delivery side there are 8 cases where the number of refiners exceeds the number of pipelines, 8 cases where the number of pipelines exceeds the number of refiners, and 4 cases where the numbers are equal. Looking at the product collection side, there are 6 cases where the number of refiners exceeds the number of pipelines, 9 cases where the number of pipelines exceeds the number of refiners, and 5 cases where the numbers are equal. This suggests that the degree of market power on the part of refiners is at least equal on average to the degree of market power of pipelines. If buyers of pipeline services typically have market power (as measured by concentration) at least equal to sellers how can there be a danger of sellers systematically exploiting the buyers?

Also, in light of these facts, NERA's argument that pipelines are uncompetitive is by implication an argument that refiners are also uncompetitive. Yet few would accept the latter, suggesting that it is NERA's methods that are suspect,not the refining or pipeline industries.

* * * * *

(6) NERA assumes that all parties to any joint venture pipeline regardless of how small their ownership shares are in perfect collusion, not only with respect to the joint venture line but also with respect to operations of any separate lines owned by the joint venture partners serving the same markets. Therefore, all companies related by a joint venture are treated as a single competitive entity in their concentration figures. NERA offers no arguments based on economic theory, history of the pipeline industry or oil industry, or analogies from other industries to justify this assumption.

In my report I remove a joint venture pipeline as a competitive entity if a majority of ownership of the line is represented by companies with separate pipelines serving the same market. If each pipeline acted _independently_ and in its own interest, it is _possible_ that a majority would choose a course of action in pricing or expansion that would represent their separate interests and not that of the joint venture line as an independent competitive entity. This possibility, the probability of which is indeterminate, is a reasonable cause to treat such a joint venture line differently. My removal of it as a competitive entity represents an assumption about these probabilities that is extreme in the direction of reducing the estimate of competition.

NERA, in contrast, assumes that the fact of a joint venture implies a continuous conspiracy among all its members in all their operations in the particular market. Furthermore, this conspiracy is assumed to be perfect in that all its members act as one.

That NERA does not seriously attempt to support its assumptions is understandable. Their view that "two pipelines with an owner in common are unlikely...to be intense rivals" and that "when two or more rivals are related through one of the various types of ownership interlocks...such rivals may be less inclined to compete with each other" is hardly a basis for inferring perfect conspiracy, even if their views were accurate.

What NERA must assume is that oil pipeline companies are every day throughout the nation conspiring against their customers in violation of the antitrust laws. It is remarkable that these conspiracies have gone undetected for decades. To date there is no case on record of owners in two pipelines serving the same market being sanctioned for violations of the antitrust laws in spite of continuous observation of joint venture lines by the Department of Justice.[30]

* * * * *

(7) NERA assumes a market size in the case of crude production centers and consumption markets that is much smaller than that used by any other researcher to date. In the case of crude production the market is assumed to be the county in which the crude field is contained. In the case of consuming

---

[30] See the legal appendix for further development of this point.

areas the BEA or SMSA is assumed to define the market. No clear reason is given for choosing markets as small as a county or BEA area, but NERA states that it would be very costly to truck crude more than fifty miles (p. 52). NERA does not say how far trucks should move product.

There is a logic to assuming that trucking distance defines the size of a market. If certain refineries, pipeline terminals or ports are within economical trucking distance of a crude production area or population center then it is reasonable to say that these facilities are in competition. The question is whether a county, or BEA area, or a 50 mile range are reasonable definitions of market size.

In the first place the 50 mile trucking distance put forward by NERA is not consistent with its county and BEA definitions since counties and BEAs vary enormously in size and do not revolve around a 50 mile radius. In the second place economical trucking distances vary enormously with market conditions. The 50 mile figure might be a reasonable rule of thumb under some conditions -- higher density consuming areas or higher volume, concentrated production areas -- but would be far too low a figure under other conditions.

In the case of crude production areas trucking becomes economical relative to pipelines when volumes are small, or the estimated life of the field is short, or the wells are scattered over a wide area. Of the seven fields characterized by NERA as "high risk" (six are in Utah or Wyoming), 1981 total production was about ten thousand barrels per day and average well production about 90 barrels per day. Calculations made by Keith Bailey, President, Williams Pipe Line Company, show that for a 10,000 bpd field and 500 bpd wells, trucking would be significantly cheaper than a six-inch pipeline (the optimal size) for distances beyond 50 miles. With actual well volume much smaller and wells presumably scattered over larger areas than Bailey's assumed figures, competitive trucking would extend well beyond 50 miles for the kinds of places that NERA finds to be "high risk."

But NERA does not even use the 50 mile radius, instead choosing county lines. Obviously this is a very different approach since counties are not of uniform size of 100 miles square, and crude fields are not generally located in the center of counties. NERA rebuts this last point by arguing that while pipelines or refineries located just outside the county line would not be counted, pipelines and refineries located at the other end of the county would be.[31] The inference presumably is that, while not strictly accurate, this approach is unbiased. A little reflection, however, suggests that pipelines and refineries are not scattered randomly across the landscape. They tend to be located where the oil is, and if the oil is located near the county line the pipelines and refineries will tend to be located near the county line. We do not know which pipelines and refineries

---

[31] NERA, op. cit., fn. 68.

NERA allocates to each market, but our observation of the seven "high risk" fields that NERA cites suggests that using a radius approach of, say, 70 miles, instead of the county line, as the boundary of the market substantially increases the number of rivals. Even this approach, however, is still too general to capture the unique circumstances of each market.

Moving to the consuming markets, we find again that the markets characterized as "high risk" by NERA typically turn out to be relatively remote sparsely populated areas. Of the 17 "high risk" markets 16 were too small to be included in my study or in Hansen's. It is precisely in these sparsely populated areas that trucking distances are often much greater.

Take the case of Scottsbluff, Nebraska, BEA 145, a NERA "high risk" market. Within the BEA itself are just two competing facilities, a CRA refinery at Scottsbluff (operating in 1979, but currently shut down) and a Cheyenne pipeline terminal at Sydney. Inquiries to companies supplying product to the area indicate many more facilities linked to the area by truck or tank car:

(1) the Wyoming Refinery Co. (11,000 bpd capacity), Newcastle, Wyoming, supplies product by truck to the Chadron area (northwest part of BEA 145), a distance of about 120 miles;

(2) the C & H refinery (200 bpd) in Lusk, Wyoming, 85 miles from Chadron, supplies product to BEA 145 by truck;

(3) the Husky Oil Co. refinery (24,400 bpd) at Cheyenne, Wyoming, supplies product to BEA 145 by truck, a distance of about 40 miles to the nearest BEA boundary and 80 miles to Scottsbluff;

(4) the Glacier Park Co. topping plant at Osage, Wyoming, supplies 4,000 bpd to the Burlington Northern R.R. at Alliance, Nebraska by tank car, a straight-line distance of 110 miles;

(5) product is shipped into BEA 145 from four terminals of the Kaneb Pipe Line at Norfolk, Geneva, and Osceola, Nebraska and Yankton, S.D., all of which are more than 400 miles away;

(6) Mobil supplies BEA 145 by truck from the Mobil Pipe Line terminal in Sioux City, Iowa, a distance of over 450 miles;

(7) Champlin Oil Co. supplies BEA 145 by truck from Champlin Pipe Line terminal at Columbus, Nebraska, a distance of 388 miles;

(8) Conoco and Amoco move product by truck for the Rapid City, S. Dakota terminal of Wyco Pipe Line, a distance of 120 miles to the closest town in BEA 145.

In addition, some refineries that now ship by pipeline to Sydney are obviously within reasonable trucking distance of Scottsbluff, notably the Texaco, Little America, and Amoco refineries at Casper, Wyoming, a distance of 100 miles from BEA 145.

In summary, there are at least ten independent competing entities supplying BEA 145, of which only two are found within the BEA, and several of these rivals truck product hundreds of miles. These long trucking distances are hardly typical but neither are the market areas said to be high risk by NERA. The point is that the application of rules of thumb that might be appropriate in the markets analyzed by Hansen and myself are not appropriate in the sparsely populated areas added by NERA.

A less extreme case is Champaign-Urbana, Illinois, or BEA 84, which NERA considers to be a "high risk" market. The BEA area covers eight counties with a population approaching 400,000. In contrast industry people regard the market as extending from the barge terminals of Peoria in the west, along Interstate 74 to Danville on the Indiana border, an area covering approximately 800,000 people. There are at least ten common carrier trucking lines and several private fleets serving the area and they view an average truck haul as being about 60 miles with 80 miles regarded as a long trip.

Refiners, pipelines and barge terminals competing in this area include:

(1) Marathon

(a) a pipeline terminal in the city of Champaign

(b) a refinery in Robinson, Ill., less than 20 miles south of the BEA's southern border and 45 miles southeast of Maltoon and Charleston, the largest towns in the southern part of the BEA;

(c) a pipeline terminal in St. Elma, less than 25 miles from the southern border of the BEA and 45 miles southwest of Maltoon and Charleston;

(d) a pipeline terminal at New Goshen on the eastern border of the BEA.

(2) Shell

(a) a pipeline terminal at Harristown (Decatur), about ten miles east of the BEA 84 border (but well within the true market area) and about 45 miles from the city of Champaign;

(b) a pipeline terminal at Farmer City (not currently operating), which is on the eastern border of BEA 84, on I 74 in the center of the market as viewed by industry, and less than 20 miles from the city of Champaign;

(c) a pipeline terminal at Effingham, on the southwest border of BEA 84, about 30 miles south of Mattoon and Charleston by I 57;

(d) a pipeline terminal at Terre Haute, which is at the eastern border of BEA 84, about 45 miles south of Danville, the largest city in the eastern part of the BEA and 40 miles east of Mattoon and Charleston.

(3) Phillips

(a) a pipeline terminal at Forsyth (Decatur) about 5-10 miles from the western border of BEA 84 and 35 miles southwest of Champaign on I 72.

(4) Standard Transmission

(a) a pipeline terminal (collecting from an Arco pipeline) at Chillicothe, near Peoria, the western edge of the industry-defined market, about 60 miles from the northwestern edge of BEA 84 and about 90 miles from Champaign proper.

(5) Texaco

(a) a refinery at Lawrenceville, about 35 miles southeast of BEA 84 and about 60 miles south of Mattoon and Charleston;

(b) a barge terminal at Peoria, about 60 miles from BEA 84 and 75 miles from Champaign proper on I 74.

(6) Williams (under construction for early 84 start-up)

(a) a pipeline terminal at Springfield, about 50 miles west of the BEA 84 border about 80 miles by I 72 from Champaign proper

(b) a pipeline terminal at Heyworth, about 20 miles from the western border of BEA 84, 35 miles from Champaign on I 74, and near the center of the industry defined market.

(7) Amoco

(a) a pipeline terminal at Lafayette, Indiana, about 40 miles from Hoopeston, largest town in the northeast corner of BEA 84, and 45 miles from Danville;

(b) a river terminal at Peoria.

(8) FS Services

(a) a barge terminal at Peoria.

(9) Clark

(a) a barge terminal at Peoria.

(10) Mobil

(a) a barge terminal at Peoria.

(11) Martin

(a) a barge terminal at Peoria.

(12) Sweeney

(a) a barge terminal at Peoria.

Potential competition also exists from the Explorer Pipe Line which currently has no terminal in the area, but passes within 20 miles of Champaign and along the border of BEA 84, and the Texas Eastern pipeline which passes through Lafayette, Indiana but currently does not have a terminal.

Not included in this listing are Indianapolis pipeline terminals and a refinery, which are about 75-80 miles from Danville by I-74 and a Buckeye pipeline from Lawrenceville, Ill. through Terre Haute to the northeast which is moving product out of the area to Indianapolis and points beyond.

That the market area receives petroleum products through 12 independent entities, with potential competition from others, does not suggest a high risk of monopoly power.

Obviously, determination of the true extent of competition in a market is a time-consuming task involving a considerable amount of detail. Even our lengthy discussion of the Scottsbluff and Champaign markets is little more than an outline of competitive forces. A couple of briefer sketches of competition in markets labelled "high-risk" by NERA follows.

In the Eau Claire, Wisconsin market, labelled high risk by NERA, there are 19 terminal facilities within trucking distance, including 7 barge terminals, 3 private pipeline terminals, 7 common carrier pipeline terminals, and 2 refinery terminals. These facilities are owned, singly or jointly, by 12 independent companies, and at least 7 independent competing entities.[32] Rates charged by Williams Pipe Line to Cadott, the nearest pipeline terminal to Eau Claire, are lower on a barrel-mile basis than rates to its highly competitive Minneapolis terminal.

In Texarkana, Texas there is no pipeline delivering product within 50 miles. The nearest pipeline terminal delivering product is the Mobil facility at Waskom, Tx., about 75 miles to the south. Within the same radius of Texarkana, there are 10 refineries owned by 10 separate companies. The capacity of the Mobile pipeline is 14,000 bpd. The combined capacity of the ten refineries is 125,000 bpd. Adding just a few more miles to the radius would add several more refineries and much more refining capacity, while adding only one more pipeline delivery point. Thus, by any reasonable estimation pipelines play a small role in supplying product to Texarkana, yet the market is characterized by NERA as evidencing a "high risk" of monopoly exploitation by pipelines.

* * * * *

(8) Even if we computed concentration in product markets by correctly estimating pipeline deliveries and refinery output, a finding that the market was concentrated or uncompetitive does not imply that pipelines can exercise market power. For the market may be concentrated because refinery capacity is concen-

---

[32] Some of the facilities are jointly owned and the ownership shares are not known by the author.

trated -- pipelines may in fact play a small role in the market. It has already been observed in my report that product pipelines appear to contribute more to local competition in consumer markets than refineries.[33]

* * * * *

(9) NERA does not take account of local crude delivery by truck or pipeline within the refiner market. This is in addition to ignoring volumes of crude shipped in by water. Concentration is instead measured solely within the pipeline segment of the market.

---

[33] Mitchell, op. cit., pp. 63-65.

VI. Miscellaneous Issues

1. NERA cites the doctoral dissertation of John Hansen as offering some support for its concentration findings. The product delivery and crude delivery markets used by Hansen are essentially identical with the markets used in my study; the product collection markets are also essentially the same as those used by NERA. Since both NERA and myself have researched these markets more intensively than Hansen no further comment on these markets is necessary.

The crude collection and product collection markets defined by Hansen are unique. The data used by Hansen comes from ICC-FERC Form P. Since these data are available on a state by state basis Hansen takes the state as the market. Putting aside the question of whether the state is the appropriate market definition, inspection of the data used by Hansen suggests that the data do not represent what Hansen thinks they represent (or for that matter what any casual observer would think they meant).

We will focus here exclusively on the crude collection data. Because Hansen must rely entirely on interstate pipeline submissions to the ICC-FERC he chooses to exclude from his analysis states where less than 75 percent of state crude production is collected by interestate pipelines. That something is seriously wrong with Hansen's interpretation of the data is suggested by just a few facts:

(a) Oklahoma is included in Hansen's list of states meeting his 75 percent criterion. Yet Oklahoma intrastate pipelines collect more than half of Oklahoma's crude production.

(b) Texas is included as having met the 75 percent criterion. Yet in 1977 73.4 percent of Texas' crude production was refined within the state and 89.4 percent of the crude moved to refineries in Texas was moved by pipelines with intrastate tariffs and thus not necessarily required to include these shipments on Form P.

(c) Hansen designates the Tecumseh Pipe Line as collecting 42.3 percent of the crude collected in Indiana. Yet there is no crude production in the northwest Indiana area where Tecumseh originates. Tecumseh is merely a connecting carrier for Canadian and mid-continent crude arriving in the Chicago area.

The problem seems to be that Hansen includes some crude collected that did not originate in the state. Schedule 400 of Form P offers three categories to place crude entering a pipeline system: "from connecting carriers," "Originated on gathering lines," and "Originated on trunk lines." I infer that Hansen excludes the "from connecting carriers" category and counts the two other categories as representing crude collected in the state by the pipeline. This is unfortunately an incorrect interpretation. The last category "Originated on trunk lines" is a catch-all category, the instructions to the form directing respondents to place all oil not placed into the two previous categories into the third category.

An example of the consequences of this error involves the Texoma Pipe Line. Hansen's Table IV-1 indicates that Texoma is the fifth largest collector of crude in Texas with 6.15 percent of the market. The 79.6 million barrels collected by Texoma all come from the last column, "Originated on trunk lines." Actually, all of this oil is crude delivered by tanker to Texoma's Nederland, Texas terminal. Probably, none of it was produced in Texas, and possibly all of it was produced abroad. Falling into the same situation as Texoma are Explorer Mid-Valley and West Texas Gulf, all of which collect crude only from other pipelines or tankers in the Gulf Coast.

Since Hansen, like NERA, lumps all owners in joint ventures into one entity, the overlapping ownerships of these four lines and other joint ventures give their collective owners a market share of 62 percent. Excluding these four pipelines would reduce this market share to 17 percent. However, even this would be an inaccurate figure since the same error would undoubtedly apply to many other pipelines and intrastate collection is ignored entirely.

Since this error is likely to occur throughout the data used by Hansen we can only infer that the Hansen concentration figures are not reliable.

2. NERA at various points (for example, p. 118) argues that my study assumes that a market served by more than one pipeline is competitive. Nowhere in my study is anything like this stated. For each category of market I looked in more detail at the "worst" cases (labelled so in my study), namely, those markets with one or two pipelines serving. NERA chose not to examine any market in detail.
3. NERA rebuts my argument that the long haul-short haul clause acts to transmit competition from the long haul market to the short haul market by suggesting that this provision of the Interstate Commerce Act "could be repealed in the event of deregulation" (NERA op. cit., p. 125). Actually, there is no bill before the Congress that proposes such repeal and neither owners nor shippers have raised this issue.
4. A further example of uneconomic reasoning in the NERA paper is the argument regarding the Phoenix market: that refiners would not build a new pipeline to displace the Southern Pacific if it raised its rates above the replacement cost of a new line. NERA argues that refiners would merely raise their refined product prices in Phoenix (NERA, op. cit., p. 126), thereby offsetting the rate increase.

This clearly implies that refiners are not interested in making money since whatever the refined product prices charged in Phoenix refiners can make more money if their transport costs are lower. If the costs of a new line are less than the Southern Pacific rates then there is every incentive to build a new line. This cap on Southern Pacific rates is at the competitive level since the replacement costs defines that level. Thus, the prospect of entry at a higher than competitive price is sufficient to keep rates at no more than a competitive level.

AOPL APPENDIX TO THE NERA STUDY OF COMPETITION IN OIL PIPELINE MARKETS: A CRITIQUE

Ownership Interlocks:

On page 19 of the NERA report it is stated that "Pipelines owned by the 18 major integrated oil companies transport almost 80 percent of the crude and product moved by pipeline."

The basic reason for the majors owning a majority of the pipelines is that other companies are rarely interested in obtaining a percentage in an oil pipeline project.

At the inception of such a pipeline project the initiators seek participation by as many parties as possible in order to share the risks and costs and attempt to anticipate the volumes to be moved so as to optimize the size of the pipeline to take advantage of economies of scale. Generally, brochures concerning the project are disseminated to shippers on existing lines, producers, refiners and other potentially interested parties at the inception of the project as was done, for example, in the Seaway, Texoma, Texas Offshore Port and more recently Chisholm Pipe Line Company undertakings. At the present such solicitations are being made concerning the offshore California finds, namely Hermosa pipeline and the Gaviota pipeline project. The same is true with respect to a new west to east line to be known as the All-American pipeline.

Potential shippers know that under the umbrella of the common carrier obligations of the Interstate Commerce Act they will be able to ship on a common carrier line without owning a percentage of that line.

Even if the line is full to capacity, everyone on the line will be granted space according to a pro-rationing policy. Thus any company that would attempt to control the sizing of a new line to its own advantage may find that under pro-rationing line space may be inadequate for its own needs.

p. 21

The study cites Colonial Pipeline as being the largest joint venture and "even though owned by other pipeline companies, Colonial is regulated by the FERC as a separate pipeline company with a single schedules of rates." Obviously this is so since Colonial as a corporation is a separate entity and no matter who is a shareholder, oil company or not, this had no bearing upon the regulation of Colonial.

p. 78

The NERA study assumes that oil pipelines are competing rivals only if they have no owners in common. Thus, two or more pipelines serving the same market, but having some commonality of ownership (no matter how small), are treated as one pipeline for purposes of determining the degree of concentration in that market.

For the most part, NERA merely states this assumption and offers very little in the way of justification. For example, on page 10 of the study, NERA states, "[t]wo pipelines with an owner in common are unlikely, in NERA's view, to be intense rivals." And, on page 78, NERA states, "[w]hen two or more rivals are related through one of the various types of ownership interlocks . . ., such rivals may be less inclined to compete with each other." (Emphasis added.) There is no discussion of why NERA assumes that this is the case, and no statistics or other evidence is offered to support the assumption.

One specific example is given on page 78 -- the delivery of petroleum products to St. Louis by Continental, Phillips and Explorer (which is partly owned by the former two). Again, NERA offers no evidence to supports its assumption that there is no competition among these companies. It merely poses the rhetorical questions: "Is Explorer likely to compete with two of its owners? For that matter, would Continental compete vigorously with Phillips while meeting regularly to manage the operation of Explorer?" The impression apparently intended to be left in the reader's mind is that the only possible answer to these questions is "no." But the combined ownership of Continental and Phillips in Explorer is only some 12.22%. This is clearly not sufficient ownership for Phillips and Continental to control Explorer, even if they were to act together. And there is no justification whatsoever for the suggestion that Phillips and Continental do not compete on their own pipeline systems. NERA exhibits a cynical misconception about the level of competition in the oil pipeline industry by suggesting that Phillips and Continental can set Explorer's rates in a non-competitive fashion, or that commonality of ownership on Explorer could lessen competition between Phillips and Continental. In fact, unless the owner of a "joint venture" pipeline can exercise control, there is no reasonable basis to even make the assumption that the degree of competition could be affected at all.

Mitchell is correct in not eliminating Explorer as a rival to Continental and Phillips because the latter two companies combined do not have even close to a majority share. Phillips and Continental do compete actively with each other: each vies to attract the largest possible volume and to maximize their earnings on their own lines. Each company is a separate profit center with a separate competitive mind, and their 12.22% combined participation in Explorer cannot determine their actions with regard to their separate 100% ownership of individual lines.

The NERA study suggests that there may be collusion between shareholders in the operation of two pipelines in which they are both shareholders. This implies probable violations of the antitrust laws which are in force and have been in force for some time. To date it is interesting to note that there are no such cases on record of owners of interest in two pipelines serving the same area being sanctioned for violations of the antitrust laws. Since current antitrust laws would continue to apply to oil pipelines under proposed legislation, this situation will not change.

Undivided interests - NERA treats "undivided interest" pipelines in the same way as "joint venture" pipelines. The only basis in the study even approaching a critical analysis of why this is done is provided at pages 80-82. NERA offers two substantial reasons why owners of an undivided interest pipeline would be unlikely to be intense competitors with each other. First, NERA assumes that one owner would not be likely to reduce its rates unless it had substantial excess capacity.

Second, the owners regularly meet to manage operation of the line, and NERA assumes that this creates an atmosphere of cooperation and encourages jointly set or parallel rates.

The first reason given by NERA may have some appeal. There may appear to be little incentive for one owner of an undivided interest pipeline to lower its rates if the pipeline is operating at full capacity. However, very few pipelines (if any) operate at full capacity. And even if this were the case, the owner would not necessarily be able to raise its rates above competitive levels because of the existence of potential competition (either from another source, or from a possible increase in capacity of the existing line by the other owners). There is certainly no evidence to support the assumption that _substantial_ excess capacity is required. This notion sounds very much like the old "undersizing theory" which has largely been discredited.

Further, besides the full capacity argument, each company's expenses will differ (particularly cost of debt, taxes, insurance and working capital), which may result in each pipeline company having an interest in the system charging different rates. Generally speaking, construction cost and basic operating expenses may be the same for the undivided interest owner, but the rates are not determined by these expenses alone.

NERA's second reason suggests that the owners of undivided interest pipelines regularly engage in violations of the antitrust laws. This is preposterous, and an insult to the industry. In fact, owners of undivided interest pipelines are careful _not_ to discuss tariff matters among themselves. Each owner independently establishes its own tariff, and meetings are limited for the most part to operational matters only. Disclosure of volumes and other shipper information by one shipper-owner of a pipeline to another shipper-owner would be a violation of Section 15(7) of the ICC Act which would remain in place even if the pipelines were deregulated.

The NERA study also indicates that it may be easy to increase and decrease the capacity of the line at will. This is easier said than done. Further expansion depends on the accuracy of projected volumes. A pipeline is built to handle a certain maximum volume: when the line is full, expansion of that volume means laying a larger diameter pipeline. If the line is already of large enough diameter, but not operating at full volume, it can be expanded by installing more pump stations. Authority for expansion is only warranted if the volume is sufficient to justify such expansion. Capacity can also be increased to a limited extent by introducing a drag reduction agent in the line, which is probably the easiest and least costly of other methods. However, suffice it to say that expansion is a major undertaking by a pipeline company.

In short, the idea that capacity can be expanded or diminished at the whim of the owners is impractical.

Dividends

Another contention made in the NERA study is that those companies making capital outlays for construction of crude or products pipelines are not concerned with the amount of the rates charged by the pipeline, since such rates will be in part returned to them in the form of dividends, and that this also places them at a competitive advantage. This is then contrasted with the independent shipper who does not invest in a pipeline project but must pay the filed rates.

At the inception of a pipeline project, as stated before, everyone who is interested has an opportunity to invest and become a part of that project. At that point they may or may not be shippers on the proposed pipeline. If they are not shippers but are shareholders then they receive a return on their capital outlay like any other shareholder. The Department of Justice in the stipulation concerning termination of the Consent Decree adopts the concept that a shareholder making a capital outlay is entitled to a reasonable rate of return and has left the determination of "reasonableness" to the FERC.

As far as the rates charged are concerned, unless the owners of the pipeline can account for all of the volume necessary to fill the line, which is usually not the case, the owners must charge a rate that will attract additional volume. If these rates are so high as to be prohibitive, even under the proposed economic deregulation the shipper can still complain of such a rate as being discriminatory, but more significant would be the loss of volume which could cause further losses to the pipeline company.

Mr. ANDERSON. Please proceed.

TESTIMONY OF DONALD MERRIMAN, PRESIDENT, BUCKEYE PIPE LINE CO., ACCOMPANIED BY PAT CORCORAN, EXECUTIVE DIRECTOR AND COUNSEL TO THE ASSOCIATION OF OIL PIPE LINES [AOPL], AND EDWARD J. MITCHELL, PROFESSOR, UNIVERSITY OF MICHIGAN

Mr. MERRIMAN. Thank you, Mr. Chairman, and members of the subcommittee.

My name is Donald Merriman, and I appear here in support of H.R. 2677 on behalf of the Association of Oil Pipe Lines, an unincorporated association of 90 common carrier pipelines which together transport about 95 percent of all the crude oil and refined petroleum products that are transported in the United States in interstate commerce.

With me today is Patrick Corcoran, the executive director and counsel to the association. Also, professor Edward Mitchell of the University of Michigan who authored the study on competition in the oil pipe line industry in the lower 48 States and who I'm sure is eagerly awaiting the Department of Justice study that we were promised this morning.

Tomorrow, together with other members concerned with the Trans-Alaska Pipeline System, there is scheduled to appear Mr. Richard J. Barber, president of Richard J. Barber Associates who conducted the study of the Trans-Alaska Pipe Line System for the eight carriers owning undivided interests in TAPS.

I am an officer of AOPL and president of Buckeye Pipe Line Co., an independent pipeline company operating in the northeast quadrant of the United States.

My company is not affiliated with any integrated petroleum company.

The Association of Oil Pipe Lines unanimously endorses H.R. 2677. It economically deregulates the industry by eliminating regulatory authority to set rate levels while providing protection to the shippers by continuing our common carrier obligations under the Interestate Commerce Act.

In our opinion, both the spirit and the technical language of the bill accomplishes this purpose. At the invitation of the chairman to advise a little bit about our industry, let me make a few comments about it and what it is.

It's a mature industry; we've been around for 118 years. It's a significant industry; there are $21 billion of assets involved, over 200,000 miles of pipeline. We transport approximately a quarter of all intercity freight, and yet we do it economically at about 3.3 percent of the total Nation's freight bill.

Oil pipelines carry approximately 60 percent of all the crude barrels in interstate commerce, and approximately 40 percent of all the refined petroleum products.

Our industry is a safe industry. According to the Department of Transportation's statistics last year, there was not one fatality attributable to the operation of oil pipelines.

We're competitive, not only between ourselves, crude pipelines versus product pipelines, product pipelines against one another, but we're competitive with other modes, such as water carriers, trucks, imported product, and in addition certain tax situations in States which are severe competitive constraints to us.

I think it's important that we emphasize the difference between oil pipelines and the natural gas transmission industry which has been the subject of much discussion in the Congress recently. Only the hardware is similar.

Under the Interstate Commerce Act, entry into and exit from the oil pipeline business is unrestricted. There are no certificates of convenience and necessity, in order to build a pipeline, nor is there any restriction or permission to abandon service.

We have no franchised areas, nor any legally assigned markets. Instead, oil pipelines act as common carriers. Title to the product remains with the shipper while it's in our custody. And we are not public utilities.

The chief result of this common carrier aspect of the industry has been that competition, not regulation, is the primary determinant of oil pipeline rates.

Competition has led to winners and losers in our business as in any unregulated sector of the free market. We have no preferred customers. Anyone who makes a proper tender of shipment must have his oil carried on the same terms as others similarly situated, at the same rates, and under the same rules and regulations whether he's a large shipper, a small shipper, affiliated or not.

In the matter of rate levels, two Federal agencies have documented the fact that oil pipeline charges are a small part of the end cost to the consumer. In a 1980 decision, the FERC stated that not only is the pipeline charge a miniscule part of the consumer's total oil cost, but that end cost is in fact set by much larger market forces that make a pipeline rate increase or decrease inaudible if not wholly lost in the surrounding noise.

The FERC again reiterated this point in its *Williams* decision of last November which noted that the cost to the consumer of total pipeline transportation throughout the continental United States is only in the order of 1.5 cents per gallon.

Furthermore, a Department of Energy study examined the effect of pipeline deregulation on consumer costs, and found that even if regulation could be credited with restraining pipeline rates by 20 percent, the savings to the consumer would be approximately two tenths of a cent per gallon.

Likewise, the study noted, that even if deregulation resulted in increased rates, the range of impact on the ultimate consumer of petroleum products would not even exceed 1 cent.

The industry's legislative history is well documented. And I had a little sense of deja vu this morning as I listened to some of the proposals of the Government witnesses concerning keeping some of the aspects, or doing away with some of the common carrier aspects of the industry.

Let me emphasize that in 1906 congressional concern was not with the level of rates, but with protecting shippers from discriminatory practices. The retention of common carrier obligations, as in H.R. 2677 will continue the antidiscrimination sections of the law.

Now, recognizing the intent of the Congress, the Interstate Commerce Commission employed a light regulatory hand for decades during which shipper complaints were practically nonexistent.

I've been in this industry for 34 years, a period during which the oil pipeline industry expanded and resulted in the finest network of petroleum transportation in the world. In the last 6 years, however, the industry has been operating under a great degree of uncertainty. You might say we were mired in a regulatory morass.

This culminated in the landmark opinion of the FERC in the *Williams* case last November which was intended to establish a new economic framework for the industry.

The case is now before the U.S. Court of Appeals for the District of Columbia. This was the same court which had this case 5 years ago. If the past is prologue, we still have before us years of judicial and administrative proceedings and even if a final decision is reached, the rules would be subjected to constant reinterpretation by an agency best acquainted with strict public utility concepts.

Accordingly, we come to the Congress and ask that through the legislation that's proposed it cut the Gordian knot. FERC in its opinion suggested that it was timely for this body to consider deregulation of the industry. And in prior hearings, and this morning, the Office of Management and Budget, the Department of Energy, and the Department of Justice have basically endorsed this approach.

Indeed, as you heard this morning, the Department of Justice and others have suggested that total dereguation would insure more perfect competition. That is to allow discrimination and prohibit publication of tariff rates.

While again, we have not seen any absolute drafts of the proposals, we can foresee problems. To construct a pipeline, it is almost essential to have the right of eminent domain which flows in general from the States.

This is a right based on the concept that the facility will serve the public. If oil pipelines were not common carriers they could be privatized. It would be difficult to justify the right to condemn.

From some of the information we heard this morning, we might have to have rates which were nondiscriminatory in those States where our common carrier obligations flowed from that, but we might be able to have discriminatory rates on the other side of the State line.

If I remember correctly, it was individual companies which terminated at the State line which enabled the old Standard Oil Co. to somehow get around some of the original provisions of the Interstate Commerce Act.

The ability to exclude others from service or to offer differing terms to different shippers for the same service could have far reaching, and in our opinion, unfortunate consequences.

This type of discrimination caused the evils that the Hepburn Act cured. The antidiscriminatory portions of that act should not be removed just in order to provide a more theoretically perfect model of competition.

Now, in attempting to convince a number of different people of the value of deregulation we have attempted to indicate through studies, and to a large extent there is agreement, that the bulk of the industry is competitive.

So if you take that as the basis for deregulation, but then you say to the shippers that we can discriminate, and we can offer different rates to different people for the same service, I'm sure that whatever support there may be for deregulation from the smaller shippers may disappear.

In our particular case, we have about 120 shippers on our pipeline, and of those, some 16 or so could be classified as major oil companies.

The rest of them are of varying size, independent companies and I'm sure it would be very, very difficult for us to convince these people if we were in a position to discriminate between them and the other shippers over our system.

One other point: The ability to change rates without notice could, in our opinion, have an adverse effect on shippers. Today, a shipper can review the various competitive routings available, and he can choose the mode that best suits his needs.

But I point out that in long haul movement, transit time, ofttimes is in the order of 3 weeks and sometimes longer.

Rate changes while in transit could disadvantage that shipper who either will wind up paying more than he thought he was, or fail to take advantage of a cheaper rate.

A very great concern to me from what came out of the testimony this morning are the suggestions about deregulation. Although, obviously, we have not seen the Department of Justice study, the idea that still about one-third of the pipelines in this country, which would probably be the very largest pipelines, would remain regulated is a very difficult situation.

I don't know whether my company fits into the one-third or the two-thirds. But I am sure that some of our competitors might fall in the regulated category and for all intents and purposes I believe that would effectively regulate us.

I think the other point is that under the proposals that were made this morning, almost any new pipeline would automatically fall under regulation. The rationale being that many of the pipelines, particularly those in the frontier areas of this country, are going to be single pipelines. And under a regulation, particularly one that does not return, give an adequate return for the risks undertaken, may not be built.

I suspect that the principal new pipelines that are going to be built in this country are going to be in the frontier areas, whether it's in the Arctic, or the deep water off shore and so forth.

And I think that the proposals we heard this morning will almost insure that those will be regulated, and I think this will have a very chilling effect on that kind of construction.

Now, pipelines are rarely discrete units going from A to B. They are very typically interconnected, in competition with each other, and with other modes of transportation. To create a situation in which part of this network is regulated, while the rest is not, would be to risk havoc.

Simply trying to determine just which lines, systems, segments of lines, or specific movements might be appropriate for reregulation, or which might not could create a new regulatory mess, and continue uncertainties for a long time to come.

We're only familiar with one regulatory proceeding. That was the one before the FERC in the *Williams* case. It took a long time. It was the morass that we were in.

To consider that a whole group of new regulatory proceedings and administrative proceedings would be necessary to determine which pipelines would be unregulated and which pipelines would remain under regulation would seem to be a very difficult situation. It scares me.

We thoroughly believe that economic deregulation of oil pipelines is necessary in order to avoid the stifling of the industry primarily in the frontier pipelines. The Hepburn Act bringing oil pipelines under the Interstate Commerce Commission was not primarily concerned with rate levels, but with discrimination among shippers, thus leading to monopolization of the oil industry.

Oil pipeline rate levels are far less significant today and to consumers than they were then. The industry is now sufficiently competitive so that the market has been restraining rates, not any regulatory body.

But narrow public utility regulation and the uncertainties of the regulatory process remain a threat to the vitality of the industry.

In our opinion, H.R. 2677 provides the necessary economic deregulation, yet retains the antidiscrimination protection of common carriage. We believe that this bill merits your support. Thank you, sir.

Mr. ANDERSON. Thank you, Mr. Merriman.

Mr. MITCHELL. Thank you, Mr. Chairman.

I'll just briefly summarize my statement. The first point I would like to make is that oil pipelines have not been regulated in the past as other transportation industries have.

You're talking about an industry that has essentially been unregulated or extremely lightly regulated. It has had free entry. You don't need a certificate of convenience and necessity to build a pipeline.

You don't need permission to remove an oil pipeline.

So that what we have historically is the experience of an industry that has relied almost entirely on competition to keep its rates in line. So it seems to me that history is the guide here to what we can expect in the future.

The reason why there is a proposal to deregulate this industry is that there is regulatory capacity now in the law and, that the transferral of authority from ICC to FERC has raised the possibility of public utility type regulation growing out of the *Williams* case, and that that would be completely unsuitable for an industry such as this.

I have conducted a study for AOPL. You have a copy of that. You also have a copy of my critique of the NERA report. My original study looks at several categories of pipeline markets. It looks at consuming areas, the largest metropolitan areas of the United States.

It finds that typically the number of competitors, that is, including pipelines, refineries, et cetera, is on the order of four and a half, five, and there abouts.

I noted that the assistant attorney general from Alaska said that the *Alaskan* case was different because they had one pipeline, whereas a competitive market might have four or five. Well, if four or five is his notion of a competitive market, then that is the typical case for pipeline markets in the lower 48 States.

In addition, these pipelines compete with water transport which carries approximately half of all the oil carried by ton miles. The water transport industry itself is competitive. Very little of the water transport industry is owned by the oil industry, so there's very little overlapping ownership there.

There's dispute between my point of view and the administration. There are cases where the number of pipelines, the number of competitors, are lower than average. And the question is, In those cases are there serious competitive problems?

I have looked at what I believe to be the so-called worst cases in my study. And I find that there are, overwhelmingly, circumstances which suggest that monopoly is not a problem in those instances.

I have also looked at the profit statistics in the industry. And what I find again is that appropriately measured on a delevered basis, the rate of return in the oil pipeline industry is approximately the same as that in all manufacturing industry, namely, 9½ to 10 percent level.

Several studies show that the degree of risk in the industry is approximately the same or greater in oil pipelines than it is in other industries.

So what we have is the case of an industry with about average rates of return, and average or somewhat above average degree of risk, which is certainly consistent with competitive conditions.

A question arises as to whether those normal rates of return are due to the fact that regulation in the past had some effect. I have looked at this, and in tables that are contained in my report, the data seem to indicate that that is not the case, that historical regulation by the ICC really had very little to do with the rates that were charged, and that it was probably true in only a few cases that the Elkins Act consent decree had a significant effect on rates.

I would just like to conclude these, my first remarks, by commenting on some of the things that I've heard this morning. I anxiously await the Justice Department study and its structural analysis of these markets.

I've been anxiously awaiting it for a long time.

I heard mention that the BEA area will be the unit used in the study of these markets and I point out to you that this was the same unit used in the NERA study which has been referred to.

In my critique of the NERA study, I spent almost half of the 58 pages critiquing this kind of structural analysis. First of all, I don't believe that it is typically the case that the BEA area corresponds to the appropriate market. I found in some of the high risk cases that I analyzed, high risk as characterized by NERA, that most of the competitors were not located within the BEA area, because the true market area was much larger than the BEA area.

I would also warn the committee about the idea of a simple index which would indicate whether a market was competitive or monopolistic or whatever. First of all, I don't believe the data are available at this point to compute such indexes of concentration on a BEA basis.

NERA attempted to do this, and I believe, made an enormous number of errors which multiply the degree of concentration enormously.

I do not know what Justice has done in this case, but I think that it should be looked at very carefully before one accepts their approach as a valid one for determining competition. Thank you.

Mr. ANDERSON. Mr. Corcoran.

Mr. CORCORAN. Mr. Chairman and members of this subcommittee, my name is Patrick Corcoran. I am executive director and counsel to the Association of Oil Pipe Lines. While I am available to help answer any questions you may have for the association's representatives, my primary purpose here today is to offer for the record the industry's critique of a recently issued paper on oil pipeline regulation prepared by Mr. James Love of the Center for the Study of Responsive Law.

Mr. ANDERSON. So ordered.

[Statement referred to follows:]

Critique of 1983 Study on Oil Pipeline Regulation
by James Packard Love of the
Center for the Study of Responsive Law

Association of Oil Pipe Lines

On September 26, 1983, the Center for Responsive Law released a paper entitled Oil Pipeline Regulation, written by James Love, a student at Princeton University.

Purportedly chronicling the "sorry state of oil pipeline regulation" and calling for more government control over rates, the paper does not undertake independent research of any of the subjects considered, nor does it offer new data or facts. It is not in any sense of the word a study. Rather, it is an adversarial statement reviewing from its own bias other studies, rendering an abbreviated and omissive version of the history of oil pipeline regulation, and attempting to resurrect previously discredited theories and assertions. The latter is perhaps pursued on the premise that however groundless, if a charge is repeated often enough it has the hope of taking on substance.

The paper frequently makes sweeping allegations without citations of specific evidentiary support, and conveniently 'forgets' pivotal cases and administrative decisions. It employs and characterizes investigations, which never resulted in legislative or judicial action, as final authority for conclusions of industry culpability. And it attempts to interject issues that are not germane to the present legislative proceedings.

A brief critique follows:

Economies of Scale

The paper repeats an age-old allegation that the economies of scale technically possible in the industry are the most important factor in the success of a pipeline, and the most likely reason that monopoly power can exist in the industry.

On pages 5-19 of his study*, Dr. Edward Mitchell discusses in detail why economies of scale do not lead to such a conclusion. Indeed, Dr. Mitchell points out that the need for service differentiation, changing demand patterns, and the uncertainty involved in routing an immovable pipeline result in a world where parallel pipelines are the norm rather than the exception. But more importantly, Dr. Mitchell notes that if economies of scale were the dominating factor, as some assume them to be, pipelines with large diameters would be the most profitable. Yet he finds that pipe size is not significantly correlated with the various companies' de-levered return on total capital.

In short, a careful study of the question of the influence of economies of scale leads to the result stated by Mitchell on page 19: "(T)hese findings suggest that building the right sized line in the right place at the right time with the right package of services is infinitely more important than building a large line."

Barriers to Entry

The paper cites as barriers to entry rights of way and environmental permitting hurdles, and capital expenditure requirements.

* A Study of Oil Pipeline Competition, April 1982

Acquiring rights of way as common carriers under state statutory and common law, as well as complying with environmental regulations, is simply business as usual for liquid pipelines. This has not impeded the building of tens of thousands of miles of new pipelines and extensions in the past decade and a half, and many of these new lines were constructed in such environmentally sensitive areas as the Outer Continental Shelf and Alaska.

Another barrier cited is that those entities desiring to invest in an oil pipeline project are prohibited because of related costs. This is not the case. True, the industry is capital intensive, and main crude trunk or product lines are usually constructed by one or more companies having a sufficiency of financial resources and a need for the transportation facilities. Still, at least fifty distinct corporate entities are in the business.

Generally, when a prospective pipeline project is in the planning stages, the initiators will inform all those who might be interested in participating. This is done both through the media and in presentation meetings with detailed descriptions explaining the project. Anyone interested can then "buy-in" to the enterprise. Frequently, only those in the oil industry, including cooperatives in the oil industry, may be desirous of purchasing interests. But, often non-integrated companies or those in wholly unrelated industries engage in pipeline activities (witness the recent construction of the Seminole and Frontier pipelines, and planned projects such as the TransGulf, Northern Tier, Pacific Texas pipeline and All-America pipelines). Further, it is suggested than an existing and operating firm will deter the entry of a possible competitor by "bidding" down prices to marginal costs. Such a predatory pricing practice, if it were to occur, would be subject to antitrust remedy.

The paper is simply misleading in its assertion that "independent oil companies carry a mere four percent of crude and one percent of product." A more accurate figure would be 23 percent for crude and 19 percent for product.*

Long Term Contracts

The paper states that long term contracts reduce "shipper flexibility." The usage is ambiguous. If by long term contracts Mr. Love is referring to through-put commitments, he is in error. A through-put commitment is a long term guarantee that unless sufficient volumes are tendered to meet the carrier's expenses and obligations the deficits will be met by the guarantor. Those guarantees are used as collateral, if you will, to obtain financing for pipeline projects. If through-put commitments did not exist, shippers with product or crude to transport would find fewer pipelines being built and thus fewer transportation facilities available.

If, on the other hand, by long term contracts Mr. Love is referring to tariffs, there are relatively few long term contract tariffs. And some of these tariffs are not actually long term contracts because the pipeline company gives the shipper the option to terminate in the event the carrier chooses to increase the tariff. Purely intrastate lines may be governed by long term contracts. However these lines are not federally regulated nor the subject of the proposed legislation.

---

* This comprehends companies other than those designated as the 18 major oil companies.

In any event, long term contracts are not a relevant concern since any potential problems associated with long term tariffs or through-commitments will still be subject to the discrimination provisions of the Interstate Commerce Act which will remain intact after deregulation of oil pipelines becomes effective. Further, any anti-competitive effects can be remedied by application of the anti-trust laws.

Undersizing

This is a peculiar theory that has been in search of facts. Briefly, it assumes that a pipeline is the least expensive method of transportation and that its owners deliberately undersize it's capacity so that a portion of product or crude must travel by a more expensive mode to a downstream market. The difference in price is a "wind fall" to the owners. Under the Interstate Commerce Act all the companies are required to have pro-rationing politices to accommodate their shippers. While some pipelines have at times been pro-rated, the data collected by a DOE survey demonstrates that it has not been a general problem, and that the pipelines have an excellent record of responding by providing new capacity. (See attached letter.)

As to allegations regarding the undersizing of Deepwater Ports, one, Seadock, was never constructed. The other, LOOP, when completed even a reasonable critic would have to conclude was, if anything, "over-sized."

Consent Decree

Although the writer purports to recite a lengthy and inclusive history of pipeline regulation from 1906 to 1980, he ignores a major Supreme Court decision which substantiates industry practices.

Mr. Love states on page 12 that the 1941 Consent Decree was "subverted" by the industry despite attempts by the Department of Justice to clarify the decree's intent. Yet in 1958, when the Department employed a case involving the Arapahoe Pipe Line Company to "clarify" the decree's intent, the district court found the decree:

> " . . . clear upon its face: but even if there had been ambiguities, (the Court) would be constrained to hold the ambigu had been resolved through the practice of the defendants, acquiesced in by the Government after full disclosure throughout the 16 years."

In a 6-1 decision affirming the industry's interpretation, the Supreme Court stated:

> Where the language of a consent decree in its normal meaning supports an interpretation; where that interpretation has been adhered to over many years by all the parties, including those government officials who drew up and administered the decree from the start; and where the trial court concludes that this interpretation is in fact that one the parties intended, we will not reject it simply because another reading might seem more consistent with the Government's reasoning for entering into the agreement in the first place.

Not only does the judicial record fail to support the implication Mr. Love wishes to leave with the reader, but that record's most recent entry makes his point moot: after negotiations with the companies covered by the 1941 decree, the Consent Decree was vacated on December 13, 1982, by the United States District Court for the District of Columbia. It therefore is irrelevant to the issue at hand.

Administrative Changes

Contrary to the paper's assertions on page 15 that there have been radical, and partisan, recent changes in direction with regard to regulation of oil pipelines, the industry has long been regarded as unique and appropriate for a "light" regulatory hand. This was the circumstance for more than seventy years at the ICC under many different administrations.

As the United States Court of Appeals for the District of Columbia observed in a 1978 decision:

> "[W]e may infer a Congressional intent to allow a freer play of competitive forces among oil pipeline companies than in other common carrier industries and, as such, we should be especially loath uncritically to import public utility notions into this area without taking note of the degree of regulation and of the nature of the regulated business."

The FERC 1982 Williams decision reinforces points made by the agency in its 1980 Buckeye decision under the previous Administration. Both decisions acted on a basic premise that the oil pipeline industry was very different from other industries regulated by the FERC. In

Buckeye, the Commission stated (p. 10):

> From a consumer-welfare standpoint, oil pipeline rate increases are a horse of an altogether different color from increases in the wholesale cost of electric power and natural gas.

The differences between the oil pipeline and other regulated industries are particularly evident when gauging consumer impact. As the Buckeye decision pointed out (pp. 9-10):

> In oil, however, we deal with a relatively small regulated portion (pipeline transit) of a vast unregulated whole (oil). Hence the prices people pay for gasoline, for heating oil, and for other petroleum-based products are determined not by regulatory concepts but by market forces . . . Normally . . . the pipeline charge does not bulk large in the price of the end-product. Moreover, market prices are influenced by such a variety of forces and factors that a pipeline rate increase (or for that matter a decrease) can well be rendered inaudible by, if it is not wholly lost in, the surrounding "noise".

Wellhead Values

The paper asserts that deregulation of oil pipeline rates will encourage evasions of the windfall profits tax.

While the transportation tariff does play a role in setting the wellhead price of oil in Alaska, such is not necessarily the case in the lower 48 states. Unfortunately, Mr. Love's limited experience with the oil pipeline industry does not give him an adequate understanding of how wellhead prices are set in the rest of the country.

More importantly, Mr. Love fails to acknowledge the testimony of the Department of the Treasury before the Senate Energy Committee hearings on oil pipeline deregulation last year, in which Deputy Assistant Secretary David Glickman stated:

> "[T]he rules relating to the determination of the removal price for calculation of the windfall profit tax, in all but one instance, (TAPS) operate independently of other costs, including pipeline transportation costs. If, as is proposed in S. 1626, oil pipelines are deregulated, related producer and pipeline companies would not be able to avoid the windfall profit tax by setting an artificially low removal price for crude oil and recouping the lower price by setting an artificially high rate for transportation of their oil alone."

Small Shipper

The suggestion that small shippers could be charged monopoly prices or "otherwise" discriminated against, and barred from pipeline ownership, is unsupported. Over the years there has been a dearth of shipper complaints. The independent producers have testified in favor of industry positions regarding rate methodology. The proposed legislation continues shipper protection against discrimination by retaining appropriate provisions of the Interstate Commerce Act and continuing a forum for complaint in the Federal Energy Regulatory Commission.

After a pipeline has been constructed and proved a viable enterprise, it is not surprising that those who have borne the risk and cost might be reluctant to sell their ownership or vary its percentage on the basis of fluctuations in shipper quantities. What is difficult, as noted earlier, is enlisting possible shareholders before a project has proved its worth, when risk and uncertainty are high.

Ownership agreements with respect to expansion are pro-competitive, not anti-competitive, in that they require participation if a sufficient number of owners agree, and no example is cited of their being employed to preclude further developments to a pipeline system or further expansion of a system.

Effects on Consumers

Current information on the likely impact on consumers of oil pipeline rate deregulation does not support Mr. Love's fears. Available predictions based on solid, reputable research by a number of sources reach results contradicting the unsupported assertions of the paper. First, as noted above, the FERC in its 1980 Buckeye decision noted that the oil pipeline industry is not in a position to significantly affect consumer prices (p. 10):

> "Moreover, market prices are influenced by such a variety of forces and factors that a pipeline rate increase (or for that matter a decrease) can well be rendered inaudible by, if it is not wholly lost in, the surrounding "noise."

Second, the FERC, after studying this industry for a considerable period, concluded in its recent Williams decision (pp. 168-9):

"For the contemporary American consumer, the most significant thing about the oil pipeline rate controversy is its utter insignificance. On an overall, industry-wide basis, the pipeline charge came to . . . approximately 1.5 cents a gallon."

The FERC opinion went on to state that fluctuation in consumer prices depends on whether the petroleum market is strong or weak. Therefore, any tariff increase is likely to be absorbed by producers and refiners, not consumers. (p. 109, 170). Finally, the opinion noted that even if an oil pipeline rate decrease could be passed onto the consumer, it would be "submicroscopic." (pp. 172-3)

Third, Dr. Edward Mitchell's study on competition in this industry stated that competition, not regulation, was responsible for holding down pipeline rates and, therefore, consumer impact. (p. 3, pp. 41-56)

Fourth, while Mr. Love relies on a 1982 Department of Energy study entitled "Petroleum Pipeline Deregulation: A Competitive Analysis" as a source document, he fails to cite its discussion of the lack of consumer impact under possible deregulation. (p. 241) That study gauged the effects of regulation and deregulation on consumer prices. Using 1979 data, the study noted that even if regulation restrained oil pipeline rates by 20 percent, the savings to the consumer were only .4 cents a gallon. And if deregulation resulted in a drastic 100 percent increase in rates, the cost to the consumer would go up only 1 cent per gallon.

Fifth, Mr. Love ignores the work done in 1980 by John Hansen, which included a conclusion that economic deregulation of oil pipelines would not measurablyincrease or decrease consumer costs. (p. 171)

In short, those entities and individuals who have studied the industry in depth have reached the conclusion that the impact of oil pipeline deregulation on consumers raised no cause for concern.

Exploitation of Upstream Producers

Although the paper states that pipeline owners could exploit upstream producers and strongly implies that they will, Mr. Love ignores several points.

First, if such exploitation is the certainty that Mr. Love implies, one would assume that independent producers would be quite concerned about the issue of deregulation. Yet no reservation has been expressed by the Independent Petroleum Producers Association of America, whose thousands of members are all upstream producers. This may in part be due to the fact that pending legislation would not repeal the industry's common carrier obligations, a fact that Mr. Love does not acknowledge.

Second, Dr. Edward Mitchell noted in his study that the "most striking" characteristic of the crude production markets is that the vast majority of them have substantial competition even without the option of pipeline transportation. (p. 74)

Third, the results of a recent study by the National Economic Research Associates indicate that far from being the most likely shippers to suffer under deregulation, crude delivery markets are the most competitive markets (p. 11, pp. 104-108). Again, while Mr. Love is certainly not bound to reach the same conclusion, he offers absolutely no serious research on which to base his allegations.

In summary, the paper is undeserving of serious consideration.

ASSOCIATION OF OIL PIPE LINES
SUITE 1208
1725 K STREET, N. W.
WASHINGTON, D. C. 20006

PATRICK H. CORCORAN
EXECUTIVE DIRECTOR

TELEPHONE (202) 331-8228

February 12, 1981

Mr. Leonard Coburn
Acting Director
Office of Competition
Department of Energy
7E-088 Forrestal Building
Washington, D.C. 20585

Dear Mr. Coburn:

The Association of Oil Pipe Lines appreciates this opportunity to comment on the draft study, United States Petroleum Pipelines, An Emperical Analysis of Pipeline Sizing. These remarks are directed to the general content, with the expectation that where reference is made to individual pipelines, those entities will respond as they determine necessary or desirable.

The Association has supported and assisted in the Department's endeavor to acquire accurate and pertinent data to inform itself as to the validity of the so-called Justice Department "undersizing theory." We are delighted that the objective data produced by the survey confirms what we have long known to be the facts, to quote the draft study, "The results suggest that proration has not been an endemic part of the system, but has occurred sporadically in most pipelines as a result of temporary situations. Normally, the pipelines have adjusted their operations to alleviate long-term proration situations." (Page 60.)

And we concur wholeheartedly in the conclusions of the study that:

- pipeline undersizing is not a general problem in the petroleum pipeline industry
- enactment of industry-wide measures such as divestiture legislation are not warranted
- no broad-scale rulemaking proceeding by the Federal Trade Commission is appropriate

- oil pipelines have an excellent record of responding to high utilization or proration by providing new capacity to meet capacity constrictions

- none of the nine pipeline systems that have met the "threshold" portion of the survey's test has been shown to meet the necessary conditions of the Department of Justice undersizing theory or to warrant antitrust enforcement action.

The draft study is also to be commended for its recognition of the degree and variety of uncertainties confronting the industry and the difficulties for pipelines in responding to quick-changing, often totally unpredictable external circumstances.

The study observes that, "... external factors such as the change in Canadian export policy, the decline in domestic production and increase in crude oil imports, the potential new pipelines from the West Coast, environmental problems, supply/demand uncertainties and alterations to ratemaking methodologies all have an impact upon pipeline planning and operation." (Page xv.) These, and many other factors, can and do have an effect on pipeline utilization.

Regrettably, after examining the data and other information elicited by the survey for the specific purpose of a sizing analysis, and after making an objective analysis and arriving at the above mentioned objective conclusions, the study repeats many of the old assertions, inferences and allegations that find no basis in the data, and are in fact refuted by those objective data. These assertions and inferences - which even the author of the study acknowledges are "interpretive", "subjective", "suggestive", etc. - create, in too many instances, a misleading impression and seriously and unneceessarily flaw the quality, integrity and fairness of the work.

Additionally, many extraneous observations - from rate methodology to deepwater ports to questions of access - are infused into the study and color it with negative implications - and none find support in the survey information. The author interjects as Appendix VIII, an "evidence memorandum." This memorandum is not evidence, but is a recantation of a collection of tired, thoroughly refuted allegations and its inclusion can at best be characterized as mischievous and prejudicial.

Basic fairness requires that the Department's analysis and conclusions be limited to, and supported by, the data obtained by the survey.

To rectify these shortcomings we specifically recommend:

- Deletion of the disclaimers on pages x and 8 as to the veracity of the data. There is nothing to "suggest" that DOE was denied access to any information requested, that the industry or any individual companies were not more than forthcoming, or that any inaccurate information was provided. To imply otherwise is unseemly. If DOE feels that any data should be spot-checked, let that be done rather than implying that furnished data may not be reliable.
- Appendix VIII, the "evidence memorandum" be deleted as a gratuitous rendition of the author's biases* and prejudices which are not supported by the data. Also, appendices II, III and IV should be deleted, as these appendices have no bearing directly or indirectly on the data elicited by the survey.
- In referring to the so-called Kennedy Petition to the Federal Trade Commission, some acknowledgement be made that the Commission declined to act favorably on the petition's request.
- References to ongoing ratemaking proceedings and methodologies in litigation be deleted as beyond the scope of the survey and the jurisdiction and competence of the Office. (".. the valuation procedure ..... is now archaic." Appendix IV, p. 18.)

---

*The author was at least one of the contributors to the Report of the Attorney General, Pursuant to Section 7 of The Deepwater Port Act of 1974, on the Applications of LOOP Inc. and Seadock, Inc., for Deepwater Port Licenses, dated November 5, 1976, and Oil Company Ownership of Pipelines, Staff Report of the Subcommittee on Antitrust and Monopoly of the Senate Judiciary Committee, dated June 1978.

- Characterizations of statutes and rate regulation be deleted, "Since the purpose of effective rate regulation is to preserve the low costs attributable to pipeline transportation ...."

- Other extraneous observations such as those appearing on pages viii, 2, 3 and 6 be deleted, to wit: "Moreover, other issues concerning the competitiveness of oil pipeline transportation have been raised over the years. These issues include access to the pipeline network or individual pipelines; service requirements for using individual pipeline systems; ownership structures (individual ownership or joint ownership); rate structures; proration policies, overall regulatory effectiveness, and other issues." Pages 5-6.

- Deletion of a multitude of inconsistent and suggestive statements, including "The general trend analysis leads to the conclusion that there is some cause for concern about the system in general ...." p. xii. "The overall picture presented is suggestive, but not conclusive." Pages xiii, 134. "From the ownership pattern one may be tempted to conclude that majors prorated their pipelines since they have greater incentives to undersize since the dominate the various markets where undersizing may occur." p. 135. "The study has not examined any upstream or downstream markets except in consideration of the 'subjective' condition." p. ix.

- The survey arbitrarily selects a figure of 94 percent utilization and the author, without justification, adopts the theory that "at some point the explanations become suspect if capacity constraints persit for an extended period of time." p. xxi, and see pp. xii, xiii, 34. Justifiable circumstances are justifiable circumstances, regardless of time periods. While the draft study does note some external circumstances, it often cavalierly dismisses them, i.e. "Further examination of the situation does not provide convincing evidence of extenuating circumstances." At page xxiii.

- Deletion or a restatement of the statistics appearing on pages xxvii and 141, namely, "Based on barrel miles, they account for 40.31 percent of the market", and "Based on throughput, the nine account for 21.15 percent." These quoted statistics are not meaningful. Totals that could not be moved through these segments due to capacity limitations compared to industry totals might be a meaningful statistic. As presented, these figures could easily mislead one to believe that pipelines are unable to transport 40.31 percent or 21.5 percent of market requirements.

- The study also recommends that the Form EIA-184 be continued "in a more limited format." To co-operate and collect the data has been a time consuming and substantial burden on the industry. The results demonstrate that there is no reason for its continuance. Existing information and the National Petroleum Council survey provide sufficient data for national security purposes. No positive cost/benefit has been shown to justify further imposing upon the industry.

In the Association's judgment, the undersizing theory has long been a theoretical idea in search of facts to substantiate it. No such facts have been revealed in the sizing survey. Even the draft study - which acknowledges that the theory has no validity - falls into the trap of further adjusting a theory to fit selected "facts" (albeit, in the case of only nine pipelines).

We would urge that the report delete the ennumerated inaccuracies, to remove the innuendoes, extraneous observations and appendices including the so-called "evidence memorandum" so as to more faithfully and fairly reflect the survey results.

Sincerely,

PHC:les

cc: Dr. William W. Lewis

Mr. Anderson. Thank you very much for your presentations, all three of you.

Mr. Merriman, on page 6 of your statement you discuss the *Williams* case and its conclusions that the transportation cost of a gallon of oil is 1.5 cents. You then referred to a Department of Energy study that noted "that even if deregulation resulted in increased rates, the range of impact on the consumer would not even exceed 1 cent per gallon."

Now, approximately how many gallons of fuel are transported by the industry on an annual basis and how would a 1-cent-a-gallon increase affect the financial condition of the industry?

Mr. Merriman. Well, the total demand of this Nation of refined products is in the order of 15 million barrels a day. Of that we have concluded that some 40 percent of refined products and 60 percent of crude is being transported by pipeline.

I have not made the numbers that you have talked about. However, I would be happy to make those calculations and present them to you.

Mr. Anderson. If you would, we'll keep the record open.

In your opinion would the current regulatory scheme allow for a 1-cent-a-gallon increase in transportation costs?

Mr. Merriman. I would think that a 1-cent-per-gallon or 42-cent-a-barrel increase on average for the country would probably not be sustainable under the Williams regulation.

Mr. Anderson. Mr. Merriman, in your opinion what effect would an increase in the transportation cost have upon taxes paid by the oil industry to the Federal Government and to State Governments.

Mr. Merriman. An increase in the cost of transportation have on the taxes paid by the oil companies?

Mr. Anderson. Yes.

Mr. Merriman. As far as their income taxes?

Mr. Anderson. Income taxes, Federal and State, whatever else they might pay, yes.

Mr. Merriman. I'm afraid, sir, I don't have that information.

Mr. Anderson. Could you get that for the record also?

Mr. Merriman. I would be happy to do that, yes, sir.

[The information received from Mr. Merriman follows:]

ASSOCIATION OF OIL PIPE LINES
SUITE 1205
1725 K STREET, N. W.
WASHINGTON, D. C. 20006

PATRICK H. CORCORAN
EXECUTIVE DIRECTOR

TELEPHONE (202) 331-8228

November 29, 1983

Honorable Glenn M. Anderson
Chairman, Subcommittee on Surface
Transportation
House Public Works and Transportation
Committee
2165 Rayburn House Office Building
Washington, D. C. 20515

Dear Chairman Anderson:

During the hearing before your Subcommittee on November 9, 1983, concerning H.R. 2677 and regulatory reform of oil pipelines, you inquired as to the effect of a one cent per gallon increase in the tariff rate on the financial conditions of the industry.

Attached is a schedule for 1982 indicating the number of crude and product barrels/gallons delivered. These figures contain an overstatement because they comprehend barrels delivered from one pipeline to another in transit either to a refinery or a product market. Granted this "double counting" which inflates the effect of a one cent increase, such an increase results in additional revenues of $4,275,898,200.

In 1982 on $21,942,044. billion investment the industry had operating revenues of $7,140,469,000 and net income of $2,162,447,000. (1) In the same year the average pipeline tariff was 1.7 cents per gallon. (2) An increase of one cent or $4,275,898,000 as computed on the schedule or as applied to the industry-wide average tariff would then mean a total increase in revenues of approximately sixty percent (60%), (3) and a net income increase of approximately two hundred and twenty per cent (220%), assuming little or no increase in operating costs and not accounting for taxes.

---

(1) Oil and Gas Journal, November 28, 1983, page 104.

(2) Operating revenues of $7,140,469,000 divided by 427,589,820,000 gallons of crude and products delivered by pipeline.

(3) Mr. Merriman's testimony referenced a 1982 Department of Energy study which, using 1979 numbers and apparently removing the "double counting" effect, found a one cent tariff increase to represent a one hundred percent increase in total revenues.

While there is "rough justice" in these numbers, I believe they provide a measure responsive to your inquiry.

In addition, you asked a question during the hearing about the effect any increase in pipeline rates would have on taxes paid by the industry. It is my understanding that your exchange with Mr. Merriman near the end of the hearing [pp. 167-8 of the transcript] answered your question in regard to the lower 48 states. If this recollection is incorrect or if you would like more information we will be glad to supply it.

Sincerely,

Attachment
PHC:les

1982—AFFECT OF ONE CENT PER GALLON PIPELINE RATE INCREASE ON TOTAL REVENUE

	Barrels delivered	Gallons delivered	Increase
Crude	5,967,624,000	250,640,208,000	$2,506,402,080
Products	4,213,086,000	176,949,612,000	1,769,496,120
Total	10,180,710,000	427,589,820,000	4,275,898,200

[1] Increase in total revenue for 1 cent (gallon) rate increase.

Source: Oil and Gas Journal, November 28, 1983, page 104.

Mr. **Anderson**. Mr. Mitchell, would it be correct to characterize your testimony as standing for the proposition that economic regulation of the oil pipeline industry has not created major problems so far, but that a change in policy at the administrative level needs to be precluded by legislation?

Mr. **Mitchell**. I think that's right, in the sense that it has not really been regulated, and if a change were made which caused it to be regulated in the traditional way of regulating industries, that it would—it's for that reason that we need this legislation, to avoid that.

Mr. **Anderson**. Your answer in a sense is "yes." If that is correct, why after 77 years of regulation do you believe that there will be an administrative shift in regulatory policies that would adversely affect the industry?

Mr. **Mitchell**. I think it's primarily a shift in bureaucracies. I believe that the ICC, when it originally was given this assignment understood that this was to be lighthanded, and proceeded in that way. But then when it was switched over to the FERC staff, you had a group who were accustomed to regulating gas pipelines which have always been regulated as public utilities, and so the presumption was that this was another gas pipeline kind of situation.

That would be my interpretation.

Mr. **Corcoran**. Mr. Chairman, could I elaborate on that a little bit?

Mr. **Anderson**. Sure.

Mr. **Corcoran**. I think what we have to make clear is that at the ICC up until the transfer under the Department of Energy Organization Act of 1977, that the 70 years we're talking about, the ICC did not act unless there was a complaint by a shipper. And since complaints by shippers were few and far between there were practically no cases.

The ICC established a regulatory framework back in 1940 and 1941, and that stayed in effect until the transfer of jurisdiction.

Back in the early 1970's, a rate case, the Williams case, started at the ICC. It's the same case that was earlier referenced to being in the Court of Appeals here.

That went up to the Court of Appeals in 1978 as has also been referenced. The FERC, the new regulatory agency, came in and asked that the case be sent back to them for them to have a crack at it.

The staff at that time at the FERC took the position throughout that the industry should be regulated like a public utility on an original cost basis. With this type of background, there is a concern that the staff in the future could again propose such a type of regulation.

Further, we haven't got any kind of resolution out of the courts. This case could go to the Supreme Court. It could be remanded. It's the type of situation where there's no certainty of having an end to this process.

I guess also we might observe, as we go along, we seem to see both in the agencies and perhaps even in the courts that they're agreeing with the industry's position more or less, but they don't know quite how to bring this process that's now 12 years old to an end.

And perhaps the Congress can give them some direction as to how to bring it to an end.

Mr. ANDERSON. I'm going to break into my questions here and recognize Mr. Wolf.

Mr. WOLF. Mr. Chairman, I thank you. I have some people out there waiting.

I don't know if you mentioned TAPS or not. I just wondered what your comments are with regard to deregulation and what the administration said with regard to the lack of competition for the Alaska Pipeline. Can you both comment?

Mr. MERRIMAN. Well, let me start that by saying that it's the position of the Association of Oil Pipelines that all oil pipelines should be deregulated. This was based on a unanimous vote by all members of the association taken approximately a year ago.

So, we're on record as favoring the deregulation of all oil pipelines. I'm not that familiar with the details of TAPS other than what has been said here, and what one reads in the press and so forth.

But it seems to me that if TAPS cost approximately half of the total investment in the total industry, that it is not untoward to see that their rates or charges be approximately half of what the total industry's rates or charges are.

Mr. WOLF. I wondered if you could comment on the factual circumstances, Prudhoe Bay, where we are up there. Mr. Mitchell commented about what is competition and there really isn't any there. There aren't any other pipelines. The other witness from

Alaska pointed out how the Midcontinent, when it was going to come down to the Michigan area is out of the Illinois area.

I agree with a lot of what you said. I just want to know if you think that's a different circumstance.

Mr. MERRIMAN. Well, because of its size and location, I think TAPS is obviously a special situation. It has to be thought of in slightly different terms than those pipelines in the lower 48.

The carriers who have undivided interests in TAPS contend that they are competitive. I have no reason to believe that they aren't.

Mr. CORCORAN. Sir, if I might add, as far as your specific questions and the factual circumstances, there are two witnesses who are going to appear tomorrow. One, Mr. Barber, who has done a study on the competitive aspects and the factual aspects, and I think it probably would be better for us to defer to his expertise as well as the other witness on these questions.

Mr. WOLF. Well, I asked you, though, because you were here for the Pipeline Association. And having been with an association for a number of years myself, I understand how you reach your conclusions but I thought it was appropriate to ask you since you were the witness from the association.

Mr. Mitchell, do you want to comment?

Mr. MITCHELL. Well, my study specifically excluded the TAPS and somebody else was doing a study specifically of TAPS. So that my knowledge of TAPS is only from what I have heard attending these hearings when sitting there listening to the TAPS witnesses and the questions and so on.

I have not looked at TAPS.

Mr. WOLF. But from your brief knowledge, and you must know a little bit more about it than what you heard today or maybe you were out of the country for the period of 1970-76, what do you think based on reading about it?

Mr. MITCHELL. My impression from what I know is that it should be deregulated along with the other lines. It's clear that TAPS cannot effect the price of oil in the downstream markets.

Mr. WOLF. Is that true?

Mr. MITCHELL. Everyone agrees to that.

The question is whether it can—the only question, as I see it, is whether it can affect the future production of oil in the Northern part of Alaska.

And it seems to me with eight separate companies owning shares in that that it is not likely to do that. It's not likely to affect exploration and production in the North of Alaska because at a minimum for the owners of TAPS, the cost of moving oil down is only the cost, regardless of what the rates charged are.

Mr. WOLF. I'd be tempted to ask you and I'm not asking you, what percentage of the votes did the owners of TAPS have in the Pipe Line Association when you took the unanimous vote.

Mr. MERRIMAN. Eight out of ninety.

Mr. WOLF. The last question is do you know of any other pipeline that was built with a specific Federal act, an oil pipeline?

Mr. MERRIMAN. No, sir, as far as I know, there was not.

Mr. CORCORAN. I think historically, during the Second World War, the Big Inch and Little Inch lines were built under the Emergency War Powers Act.

But I think that, and perhaps LOOP, but I think those are the only others.

Mr. WOLF. Thank you very much. Thank you, Mr. Chairman.

Mr. ANDERSON. Thank you, Mr. Wolf. We do have a vote, but I suppose we can take another 5 minutes there and then go vote and then come on back and complete.

I have a few more questions.

Professor Mitchell, in your opinion, has regulatory policy allowed for a fair profitability in the industry?

Mr. MITCHELL. I assume you're talking about up to today.

Mr. ANDERSON. Yes.

Mr. MITCHELL. Well, given the fact that we don't have a precise regulatory policy at this point, there is an uncertainty as to what the regulatory policy is.

But over the years, I would say the essential absence of regulation has meant that it has been possible for pipelines to earn normal rates of return. It's not been restrictive.

Mr. ANDERSON. We have so much of regulatory policy that everybody wants to deregulate it, so if we don't have one, then we shouldn't be having hearings.

Mr. MITCHELL. The problem is that we are going to get a regulatory policy at some point, and the fear is that it's likely to be one that will be along public utility lines.

Mr. ANDERSON. You mean we'll get a regulatory policy if we deregulate.

Mr. MITCHELL. If we don't deregulate, we're going to get regulation.

Mr. ANDERSON. On page 5, you state that the rate of return on total capital for the industry is close to the average of all manufacturer industries.

Could you give us a comparison to some specific industries?

Mr. MITCHELL. If you will allow me to turn to the appropriate page of my study, page 36, there is a mean rate of return over a 5 year period, 1973 to 1977.

For oil pipelines, the number is 9½ percent. Going up the list from there you have supermarkets are 9½. Retail distribution, 9.54. Food and drink 9.64. And if you jump up a few industries, you'll have steel at 10.73. Electronics 10.99, and if you jump up a little higher, you'll get information processing, 12.17, and finally, the highest on this list is finance, namely banks, 17.68.

And then we also have a few below that running down in the 8 percents, mostly. There's an extensive list there.

Mr. ANDERSON. On page 6, you say that the industry is above average in risk. Why is that so?

Mr. MITCHELL. Well, there are conventional statistical ways of measuring risk, either in the form of volatility, or in the form of something financial analysts call betas. There are three studies that have attempted to measure this for the oil pipeline industry in comparison to other industries, and the statistical measures in each case tend to come out at around average. That is the degree of volatility or riskiness, in a statistical sense, comes out at about average.

But I think what has to be added on to that is the fact that a lot of the risk in the industry is in fact being absorbed by the parent company because the Elkins Act consent decree, when it was in effect, induced companies to use heavy debt financing and to give throughput guarantees to the subsidiaries. And this aspect tends to shift some of the burden, the riskiness from the pipeline company back to the parent.

And so the purely statistical measure is probably an understatement of the degree or risk. That's why I conclude that it's probably somewhat above average in risk.

Mr. ANDERSON. I'm going to have to go vote. We'll come right back. We'll stand in recess.

[Whereupon, a short recess was taken.]

Mr. ANDERSON. The meeting of the subcommittee will come to order.

I think my last question was for you, Mr. Mitchell. In other transportation industries where there have been regulatory reform, problems have evolved with respect to price decreases. Some allege that prices are below cost or that they are predatory, and if H.R. 2677 were enacted into law, would you predict that oil transportation prices would increase or decrease and please explain your answer?

Mr. MITCHELL. I don't think they would do anything. They would just, individually on each pipeline, increase and decrease depending on conditions in that market. But there would be no particular reason to believe overall that they would change, and the reason is that the light handed regulation of the past has meant that the rates have essentially been determined by competitive forces all along, and if we can prevent a regulation from coming in and restricting rates, then they will continue to be formed in the same way as they have in the past. So there's no particular reason they would move in any particular direction.

Mr. ANDERSON. We've been involved in deregulation with trucking and airlines and buses and so on. And in those we've been told that as the result of deregulation, prices have dropped. We have been blamed for the deregulation of the trucking industry. They say it's the reason why prices have dropped so much in trucking transportation, and to some extent in the buses.

And you don't think that same experience will occur in oil pipelines?

Mr. MITCHELL. No, the difference is clear. In each of those industries that you mentioned that was deregulated you had had restrictions on entry. So that you had had protected markets in each case.

Then you unprotected them and you allowed competition in price, you allowed entry. And prices generally fell. In the oil pipeline industry, you have had free entry from the beginning, so you wouldn't be introducing free entry. So you would just continue at the same kind of competitive system that you've had all along.

Mr. ANDERSON. How do oil pipeline rates compare to rates charged by water carriers?

Mr. MITCHELL. Well, the range of rates in both oil piplines and water carriers is enormous. I indicate this in my study. That's at page 19. I indicate there some statistics on average revenues per barrel mile both for barges and for oil pipelines, and in the transportation of products. And you can see that in the sample that I have there, the range of pipeline costs was from 4.4 to 23.2 cents, and the range of barge costs was from 2.2 to 31.9.

Now, you can compute averages for that, but I submit that the averages don't mean very much because the ranges are so large. They're so different. The average rates differ tremendously because of the distance traveled, because of the size of the pipeline, the scale of the pipeline and so on and so forth.

So that you have—the bottom line is you have enormously variable rates in each case. But in general they're in the same ball park, although as I say here, it's a very large ball park.

Mr. ANDERSON. How would enactment of H.R. 2677 affect competition between the pipeline industry and the water carriers?

Mr. MITCHELL. I don't think it would affect it. I think they would continue to compete just as they do now. I don't see any change.

The concern would be that if you didn't enact this law and that we moved through the Williams proceedings eventually to some kind of regulation of rates, that you would then wind up with one industry which was regulated, the pipeline industry, whose rates were regulated, competing with another industry, water transport, which was not regulated.

And I would foresee problems for that kind of competition.

Mr. ANDERSON. Mr. Breaux?

Mr. BREAUX. Thank you, Mr. Chairman. I thank the witnesses for their presentations.

What about the position with regard to the common carrier status? The administration recommends that if we're going to deregulate pricing, that we also deregulate or remove the common carrier obligation. How do you feel about that?

Mr. MERRIMAN. As I indicated in my testimony, we are very concerned with the position of the Department of Justice and other agencies about taking out the common carrier regulation.

As we indicated, it was discrimination against the producers back in the early part of the 1900's that really led to the regulation of the oil pipeline industry. And I believe that the individual shippers today, if they were to proceed and that if the common carrier obligations of the industry were no longer valid, rather than taking a rather neutral or perhaps in some cases a favorable position to oil pipeline deregulation, would be very much against it because the smaller independent shipper would perceive that he was going to be discriminated against inasmuch as his volumes might be much smaller than some of the major oil companies.

So we are concerned about that, and certainly would not favor it.

Mr. CORCORAN. If I might add, I guess we characterize it in part as an anchor to windward to insure perfect competition in an imperfect world. As I keep reading what they're saying, they're talking about perfect competition in all of these circumstances, and therefore one should end up with no regulation at all. And yet they, themselves, indicate on the other hand that there are many instances where the competition isn't perfect, that there are variations within this, but even where the variations are, they might still be candidates for deregulation.

A further point there, I think, as we made earlier, this question of the exercise of eminent domain and the question of being able to get rights of way. We are able to acquire those now because we are a common carrier.

Mr. **Breaux**. In the States that give you eminent domain authority for your rights of way, do they require as a part of that that the pipeline be a common carrier under their State law? Can you think of any States that have eminent domain authority for oil pipelines that do not also have common carrier status requirements?

Mr. **Merriman**. We operate in 10 States, and in 8 of those States we have the right of eminent domain, and all require us to be common carriers.

As to the rest of the Nation, I'm not sure.

Mr. **Breaux**. Well, I appreciate your comments; also Mr. Corcoran's. I think that's the same thing I was saying, that the administration is saying we want to have pure decontrol, but at the same time they're saying you are going to have decontrol in some areas, but if it tends to be monopolistic, we're going to retain the controls in that area.

So philosophically I don't think they're very consistent.

Mr. **Corcoran**. Also if I might add, we have a situation now that's fairly certain. In other words, we have common carrier obligations that have been on the books for 70 or 80 years. They are not unique. They apply in similar circumstances to many other industries.

They are talking now about creating a whole new regulatory concept for the industry, or certainly for a segment of it, whether it's one-third or one-quarter or one-tenth. We don't even know what that would encompass. And the attempt to draft and create another regulatory structure for the industry, I think most attorneys would agree, would be a tremendous burden.

Mr. **Breaux**. I agree. What we really would have to do is have some whole procedure established to determine whether your are monopolistic or not. If you are monopolisitic, then we are going to continue to regulate you, so there is going to be a whole procedure that would have to be established to decide whether you fit the exemption of being decontrolled or not.

I think you ought to either be decontrolled or you shouldn't be as far as rate making is concerned.

The only thing I could get from them as to why they felt common carrier obligation should be removed is that somehow keeping it would be anticompetitive. You're the industry; do you think it's anticompetitive?

Mr. **Merriman**. Well, from my standpoint, I certainly don't believe that the common carrier regulation, or the antidiscrimination thing are anticompetitive. I believe that if you're a pure economist and you have perfect competition, yes there would be some connotations of that. But certainly as applied to the industry, I can't see that it's anticompetitive.

Mr. **Breaux**. I don't see who's asking for it. I don't know where the thrust for removing that obligation is coming from.

I think it certainly helps us from a political standpoint very candidly to get the bill passed to insure those that don't agree with it that we're talking about the fact that everybody has access to it.

The other thing that they asked for was the removal of the nondiscriminatory status, I guess, with regard to pricing. They talked about the need for flexibility and being able to change your rates. Does publishing a tariff give you problems with regard to adjusting rates as the circumstances demand?

Mr. **MERRIMAN**. Well, currently, under the present regulations, when we file tariff changes with the FERC, we also at the same time send to all of our customers or shippers the change. So our shippers are advised that same day, and the purpose is to allow them to have time to complain or file a protest with the Commission if they feel there is something wrong with the filing.

I think it's going to be very difficult on the shippers if you can change your tariff every day or every hour, or anything like that. It seems to me that you need some uniformity and you need some notice to the shippers as we pointed out in the testimony, because there is a substantial amount of transit time involved.

You may be talking if you're shipping gasoline from the Gulf Coast to upper New York State, you may be talking 3½ weeks from the time you start shipping it, and there are several carriers involved.

And whereas you may start on the first carrier at a price and be looking at price on the second carrier, and the second carrier changes that while your shipment is in progress, you're going to be paying more than you anticipate.

I think we could live with something less than the 30 days. I think that could be possible

Mr. **BREAUX**. What is the length, is there an average length of contract that you have with your shippers within the industry that's a common practice?

Mr. **MERRIMAN**. As a common practice, there are no contracts in the industry. Rates are published and available for anyone who can meet the shipping regulations that are contained in the rules and regulations.

There are some very small number of incentive tariffs that are published, which generally cover a defined volume over a period of years at a somewhat lower rate, but with penalties if you fail to ship.

But I would say 99 percent of the tariffs in effect, there are no contracts.

Mr. **BREAUX**. So in summarizing the industry's association's position with regard to the two areas, one, common carrier status, you would prefer, I take it, to see some sort of common carrier status still be included in the legislation?

Mr. **MERRIMAN**. Yes, sir.

Mr. **BREAUX**. Now, with regard to the antidiscrimination controls, am I hearing that you think that that is not a problem? Perhaps we could have a shortening of the period for which they would be published?

Mr. **MERRIMAN**. I think that might be possible. We would be happy to discuss that.

Mr. **BREAUX**. Mr. Corcoran, is there anything you wanted to add?

Mr. **CORCORAN**. As far as antidiscrimination provisions of the act as to common carrier obligations, we certainly would want to retain those.

As far as just the notice, the time when you file your tariff, whether it's 30 days, 10 days, 5 days, I think there is certainly leeway there.

I think that we are probably inclined in that direction because we want to give the shippers an opportunity to go in and complain if they've got a problem.

Mr. **MERRIMAN**. Under the current regulations, under special circumstances, like a new pipeline going into service, or some emergency where a shipper requests a special movement, you can go into the FERC and get a tariff published on less than 30 days notice, as low as 1 day.

I think one thing that perhaps should be made clear is our understanding and intent in this legislation, that although the removal of—the ability to set rates by the regulatory commission would be taken away from them, nevertheless, those rates that would be set by the carriers would be the same for all shippers for the same service performed.

So that there would not be different rates for a given level of service and volume and so forth.

Mr. **BREAUX**. Thank you very much for your presentation.

Mr. **MERRIMAN**. Chairman Anderson, one of the questions that you asked me, I think I misunderstood and I thought perhaps we could clear it up now.

In discussions with your counsel, I believe your question having to do with the taxes that might be paid to the Government, did you have reference to, for instance, the windfall profits tax as in the Alaska situation?

Mr. **ANDERSON**. Yes.

Mr. **MERRIMAN**. I misunderstood you. I thought that if we raised rates, what the impact would be on the oil companies and so forth. Insofar as the windfall profits tax, it is my understanding that only in the North Slope do you have a situation where you kind of back into the wellhead price upon which the windfall profits tax and the severance taxes and so forth are calculated.

In the lower 48 this is not the case. The purchasers of oil in the various fields set the purchase price at which they would buy the oil for a given field. They don't set a refinery gate price and then back into the field via the transportation charges.

So I think the answer would be that just as a result of an increase in a pipeline tariff in the lower 48, there would not necessarily be any change in the posted price in the field. Now, obviously the purchaser has to take into account a number of factors when he sets the purchase price, and transportation certainly may be one of them. But it is not the same as the methodology used in calculating the windfall profits tax for the North Slope.

Mr. **ANDERSON**. Thank you very much, Mr. Merriman, and Mr. Mitchell and Mr. Corcoran for your presentation.

That completes our hearing for today. Tomorrow we will meet at 10 a.m., in room 2253.

With that, today's hearing is recessed.

[Whereupon, at 4:09 p.m., the subcommittee recessed.]

REGULATORY REFORM OF THE OIL PIPELINE INDUSTRY

THURSDAY, NOVEMBER 10, 1983

House of Representatives,
Subcommittee on Surface Transportation,
Committee on Public Works and Transportation,
Washington, D.C.

The subcommittee met, pursuant to call, at 10 a.m., in room 2253, Rayburn House Office Building, Hon. Donald Albosta presiding.

Mr. Albosta. The hearing will come to order.

Today the Subcommittee on Surface Transportation resumes the hearings on H.R. 2677, the Oil Pipeline Regulatory Reform Act of 1983.

Our first witness this morning will be the Honorable Berkley Bedell of Iowa.

The full text of your prepared statement will appear in the record at this point.

[Statement referred to follows:]

BERKLEY BEDELL, IOWA
CHAIRMAN

NORMAN SISISKY, VA.
JIM COOPER, TENN.
JAMES R. "JIM" OLIN, VA.
RICHARD RAY, GA.
JOSEPH P. ADDABBO, N.Y.
HENRY B. GONZALEZ, TEX.
C. ROBIN BRITT, N.C.

United States House of Representatives
Committee on Small Business
Subcommittee on General Oversight and the Economy
B-363 Rayburn House Office Building
Washington, D.C. 20515

SILVIO O. CONTE, MASS.
SHERWOOD L. BOEHLERT, N.Y.
MICHAEL BILIRAKIS, FLA.
DAN SCHAEFER, COLO.

MAJORITY SUBCOMMITTEE STAFF
MARK J. LEVINE
CHARLES W. McMILLION
202-225-8944

MINORITY SUBCOMMITTEE COUNSEL
DONALD C. BERNO
202-225-3420

November 10, 1983

Remarks of
Hon. Berkley Bedell
Before the
Subcommittee on Surface Transportation

Good morning. I commend the Chairman for his initiative in holding these hearings on oil pipeline deregulation. I am sure that this Subcommittee will hear very compelling testimony on both sides of the oil pipeline deregulation debate.

My purpose here this morning is to inform you of the investigation into the actions of the major producers of Alaska North Slope crude oil that the Small Business Oversight Subcommittee, which I chair, has been conducting. I believe that some of the things we have uncovered have considerable relevance to the deliberations of this panel.

Last December, the Small Business Committee heard testimony from independent gasoline marketers that the major producers of ANS crude oil were using different methods of determining the value of ANS crude oil. In particular, these marketers complained that one company, ARCO, was underestimating the well-head value of their ANS crude oil and underpaying their windfall profits tax by an amount large enough to significantly lower their retail gasoline prices and

(more)

gain a substantial competitive advantage over other marketers. The three major ANS producers are Exxon, SOHIO, and ARCO.

At the request of Congressman Bill Nelson, the General Accounting Office initiated an investigation of the alleged underpayments. Although the final GAO report is not due until next month, it was reported that the IRS told the GAO the tax underpayments from the major ANS producers range between $500 to $800 million per year. (The Windfall Profits Tax Act was passed in March 1980.)

In response to strong pressure from independent marketers and members of Congress, the Treasury Department investigated the allegations and on August 8, the IRS announced a revenue ruling that seeks to clarify the proper methods to figure the removal price of a barrel of ANS crude oil for the windfall profits tax.

Shortly after the ruling was announced, however, considerable confusion over its significance, substance and intent was expressed by the parties who were following this situation.

Because of the tremendous impact such a ruling can have on the competitive factors in downstream gasoline markets, the Small Business Oversight Subcommittee held a hearing on September 15 to review the Treasury proposal.

None of our witnesses, with the exception of ARCO, expressed much enthusiasm for revenue ruling 83-124. As a result of meetings and phone conversations our Subcommittee had with the Treasury Department, Treasury announced revenue ruling 83-161 to "amplify" revenue ruling 83-124. This new ruling was met with a more favorable reaction than its predecessor. News reports indicate that this action by the

(more)

Treasury will increase tax revenues by as much as $200 million annually.

The value of Alaska North Slope crude at the wellhead for windfall profits tax purposes is determined by the market price in the nearest market minus the cost of transporting the oil from the wellhead to that market. Other producers in the lower 48 states use the market price at the port to which the oil is delivered. Arco petroleum ships most of its ANS crude oil to California, but has been computing the wellhead value as if all of the oil went to Texas, since transportation costs to Texas are much greater than to California. The new ruling denies them permission to do this.

But there are still two big loopholes in the computation for windfall profits taxes on North Slope Oil.

Revenue ruling 75-483 allows these shippers to claim as foreign source income the earnings they derive from transporting Alaskan oil outside of U.S. territorial waters. What these shippers do, and ARCO is one of them, is leave Alaskan ports, cruise just outside of U.S. territorial waters for most of their journey, and then cut back in and deliver their cargo to another U.S. port. Remember, you cannot by law export Alaskan oil. And anything shipped between American ports must be on American built and manned ships. Yet, these companies are taking a substantial part of the earnings on their shipping operations as foreign source income.

Since most oil companies have significant foreign tax credits, every dollar they charge themselves for this tanker transportation reduces their windfall profits tax by 70¢. Even without foreign tax credits, corporate income taxes are much less than the 70% windfall

(more)

profits tax, so that the more they charge themselves for transportation costs the more they reduce their taxes.

This brings me to the pipeline problem which this Committee is considering. Attached to this testimony is a letter received by my Subcommittee dated October 19, 1983 from the Federal Energy Regulatory Commission. Schedule B attached to this letter shows that Arco Pipe Line Company listed their rate of return on investment in 1980 as 15.58%, whereas the State of Alaska computes their rate of return at 43.64% per year, and the FERC staff computes annual rate of return at 34.95%.

According to FERC, which is supposed to regulate pipeline charges, current charges enable the Trans Alaska Pipeline owners to pay for its investment every three years. However, FERC has not regulated the rates They have been holding hearings since October 1, 1977 -- six years -- and their letter indicates that they still plan another year of hearings Mr. Chairman -- if this is not intentional collusion, it is inexcusable bureaucratic ineptitude.

I am not an expert in this area, but it seems to me that it should not take 10 minutes to rule on the ridiculousness of some of the things the pipeline companies are trying to get away with.

If you are in business and build a building, or buy a piece of machinery, you are permitted to depreciate the asset over a given period of time. If you have an investment of $100 depreciated over a 20 year period, with straight line depreciation, you would deduct $5 per year for depreciation, and after one year the book value of your asset would be $95.

(more)

But that is not what the pipelines are doing. They take the $5 depreciation, and then turn around and appreciate the $95 asset because of inflation and other factors so that the book value may actually be increased more than its orginal value.

This procedure enables the pipeline companies to escalate their equity and therefore justify higher tariffs and profits.

It shouldn't take FERC 10 minutes to rule this improper.

When I pay my federal income tax, I can deduct some of the other taxes I actually pay. The pipeline companies don't do this. They don't deduct the taxes paid in deriving income for computing their rate of return. They deduct the taxes from the tax table, rather than the taxes paid. Let me repeat that, Mr. Chairman. They don't deduct the taxes paid. They deduct what the tax tables show could have been paid. Try doing that on your tax return, Mr. Chairman.

It shouldn't take FERC one minute to rule on this matter.

Finally, if you are a pipeline company and want to build a billion dollar pipeline, you might put up 100 million dollars and borrow 900 million dollars. Your equity is 100 million dollars. But some pipeline companies compute their return not on equity, but on investment. If they were to receive a 10% rate of return on investment, which is less than what any of the oil companies computed on the attached list, they would receive 100 million dollars per year, which is a 100% return on investment. Do you think it should take seven years to decide whether or not a 100% return on equity per year is excessive?

The Oversight Subcommittee is very concerned about this situation. Besides being a huge drain on our Treasury, these actions can also

(more)

have an adverse impact on downstream gasoline marketing activities. Imagine being in a market where your competitors can use the tax code to pay less in taxes per unit sales than you do. We, as a panel, plan to pursue this situation further.

Mr. Chairman, the purpose of these hearings is whether or not pipeline companies should be decontrolled. I suggest that that is not the proper question. Mr. Chairman, I don't know what the connection is between pipeline companies and FERC, but it is apparent to me that for all practical purposes there is no effective control of pipeline charges.

I suggest that the question you should be asking is whether or not there should be control over pipeline charges, and whether there are any improper connections between FERC and oil and pipeline companies.

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

OCT 19 1983

Honorable Berkley Bedell
Chairman, Subcommittee on General
  Oversight and the Economy
Committee on Small Business
House of Representatives
Washington, D.C. 20515

Dear Chairman Bedell:

Thank you for your letter of September 21, 1983, requesting information relating to pipeline earnings and the history of the rates for the transportation of Alaska North Slope (ANS) crude oil through the Trans Alaska Pipeline System (TAPS). Enclosed for your information are the answers to your questions.

The rates currently being charged by the pipeline owners have not been approved by the Federal Energy Regulatory Commission (Commission). Those rates are currently under review and will be reduced if the evidence now being tried so warrants. Refunds together with appropriate interest may also be ordered.

Schedules attached hereto show the following:

A. Investment as of January 1, 1980

   Three year history of

   1. Operating expenses

   2. Interest cost

   3. Debt service cost

B. Rates of return earned on the pipeline by the four largest owners each year since decontrol. These four companies own 91.7% of the TAPS system.

C. Rate History

To the best of our knowledge and understanding and to the extent the requested information is in our files, our response is accurate. For the most effective use of our limited financial resources, our staff completed audits of only two of the respondent companies - ARCO and Exxon Pipe Line Company and performed audits on portions of the other pipeline companies. This limited investigation was sufficient in the proceeding since the State of Alaska was conducting its own investigation of each pipeline. Also, staff's evidence concerning these two companies in most instances is applicable to the other six companies as well. Most of this information has been presented by the adversary parties in the rate proceeding. The conclusions reached by the FERC Staff are being contested by the owners.

Initial rates were filed by the owner companies with the Interstate Commerce Commission (ICC) early in 1977 (The "Filed Tariffs" in the appended Schedule C). These rates average about $6.20 per barrel transported from the ANS to Valdez, Alaska. The ICC suspended these rates for the statutory maximum of seven months and substituted "interim" rates averaging about $4.84 per barrel for use during the suspension period. Upon termination of the suspension period in January, 1978, the pipeline owners commenced charging the filed rates ($6.20). The filed rates, however, are subject to refund for amounts collected in excess of rates ultimately allowed by this Commission and the Courts. The ICC suspension order and the "interim" rates were ultimately sustained by the U.S. Supreme Court.

The ICC suspension order also required that an investigation be made to determine the lawful rates which could be charged by the pipeline. That process has continued, first under the ICC, and since October 1, 1977, here at the FERC. Hearings on rate methodology were held in 1978 and 1979, with additional hearings scheduled for January, 1984. The discovery process, which permits each party limited entry into the records of each of the other parties, was initiated in 1979 and concluded in 1981. Hearings on the evidence taken during the discovery period began in February, 1982, and have continued intermittently since that time. Additional evidence on tariff rates, costs of operation, dismantling, income taxes and certain other related cost of service items is scheduled to be filed in October, 1983. Hearings on those and related allocation and tariff issues should be completed by the end of 1983. Additional evidence on construction issues is due in January, 1984, and those hearings are expected to be completed in 1984. To date, 324 days have been devoted to the hearing process, during which close to 50,000 pages of testimony have been transcribed, and uncounted thousands of pages of additional testimony and exhibits have been admitted into the record.

The Commission has ruled on a number of issues related to the proceedings, including jurisdictional matters, interest on refunds, and depreciation rates. The great body of issues are not ripe for decision at this time. However, all issues are now scheduled for hearing. Barring unforeseen procedural delays, these hearings should conclude in approximately one year. Thereafter, the presiding Administrative Law Judge will write an initial decision which in a normal case would be published within three to nine months after the close of hearings. If the Judge's decision is appealed, the Commission will then issue its opinion. Further appeals may be directed to the Federal District and Supreme Courts. Neither the timing of this chain of legal decisions nor the extent of appeals to these orders are predictable. Pending final decision or settlement, the rates filed by the owners remain in effect, subject to refund.

This Commission does not have statutory authority to regulate transportation rates for tanker shipments between U.S. Ports. Common carrier tariffs for tanker shipments are filed with the ICC pursuant to the Intercoastal Shipping Act (46 CFR part 531), commonly known as the Jones Act. Where both the ship and the oil are owned by the same company, the shipping rate is not regulated. Our understanding is that crude oil shipped out of Valdez is transported in vessels owned or leased by the owners of the crude, and are not common carriers subject to the tariff requirements of the Intercoastal Shipping Act. This subject may be explored in greater depth by contacting Mr. Charles Thompson of the ICC at 275-7720.

I believe the foregoing discussion, together with the attachments, answers the questions contained in your letter. Please contact me if your Subcommittee feels it is necessary or desirable to discuss these matters further or if you need answers to additional questions.

Sincerely,

AG Sousa

A. G. Sousa
Acting Chairman

Enclosures

cc: Representative Richard Ray
Representative Robin Britt
Representative Norman Sisisky
Representative Silvio Conte, Ranking Member
Representative Michael Bilirakis
Representative Sherwood Boehlert
Representative Dan Schaeffer

AMERADA HESS PIPELINE CORP.
Plant Investment, Operating & Interest Expenses, Debt Service Cost (000)

		1/1/80 $	1980 $	1981 $	1982 $
1.	Total Investment 1/	144,985			
	Accrued Depreciation	15,626			
	Net Plant 1/	129,359			
2.	Operating Expenses		13,971	14,429	12,264
3.	Interest Expenses 2/		6,079	4,568	3,068
4.	Debt Service Cost 3/		11,306	9,820	8,348

Source: F.E.R.C. Form P (now F.E.R.C. Form 6)

NOTE: All stated amounts are at issue before an F.E.R.C. Administrative Law Judge in the pending TAPS rate case, Docket No. OR78-1.

1/ Investment includes Construction Work In Progress

2/ Per Income Statement

3/ Includes Interest Costs

ARCO PIPE LINE CO.
Plant Investment, Operating & Interest Expenses, Debt Service Cost
(000)

		1/1/80 $	1980 $	1981 $	1982 $
1.	Total Investment 1/	1,963,042			
	Accrued Depreciation	177,311			
	Net Plant 1/	1,785,731			
2.	Ooperating Expenses		198,939	206,672	178,978
3.	Interest Expense 2/		129,129	130,390	89,035
4.	Debt Service Cost 3/		157,692	322,997	487,551

Source: Alaska Pipeline Commission Annual Report; Alaska Public Utility Commission Annual Report

NOTE: All stated amounts are at issue before an F.E.R.C. Administrative Law Judge in the pending TAPS rate case, Docket No. OR78-1.

1/ Investment includes Construction Work In Progress

2/ Per Income Statement

3/ Debt service costs were estimated from information contained in F.E.R.C. Form P (now F.E.R.C. Form 6) and/or Annual Reports filed with the Alaska Pipeline Commission or the Alaska Public Utility Commission.

BP PIPELINES, INC.
Plant Investment, Operating & Interest Expenses, Debt Service Costs
(000)

		1/1/80 $	1980 $	1981 $	1982 $
1.	Total Investment 1/	1,498,823			
	Accrued Depreciation	143,131			
	Net Plant 1/	1,355,692			
2.	Operating Expenses		149,867	153,491	138,122
3.	Interest Expenses 2/		103,330	97,294	92,071
4.	Debt Service Cost 3/		129,232	149,908	144,919

Source: F.E.R.C. Form P (now F.E.R.C. Form 6)

NOTE: All stated amounts are at issue before an F.E.R.C. Administrative Law Judge in the pending TAPS rate case, Docket No. OR78-1.

1/ Investment includes Construction Work in Progress

2/ Per Income Statement

3/ Includes Interest Costs

EXXON PIPELINE COMPANY
Plant Investment, Operating & Interest Expenses, Debt Service Costs (000)

		1/1/80 $	1980 $	1981 $	1982 $
1.	Total Investment 1/	1,830,476			
	Accrued Depreciation	178,826			
	Net Plant 1/	1,651,650			
2.	Operating Expenses		182,190	188,745	168,480
3.	Interest Expenses 2/		111,035	100,468	99,654
4.	Debt Service Cost 3/		270,829	260,110	110,154

Source: Alaska Pipeline Commission Annual Report; Alaska Public Utility Commission Annual Report

NOTE: All stated amounts are at issue before an F.E.R.C. Administrative Law Judge in the pending TAPS rate case, Docket No. OR78-1.

1/ Investment includes Construction Work In Progress

2/ Per Income Statement

3/ Debt service costs were estimated from information contained in F.E.R.C. Form P (now F.E.R.C. Form 6) and/or Annual Reports filed with the Alaska Pipeline Commission or the Alaska Public Utility Commission.

MOBIL ALASKA PIPELINE COMPANY
Plant Investment, Operating & Interest Expenses, Debt Service Costs
(000)

		1/1/80 $	1980 $	1981 $	1982 $
1.	Total Investment 1/	461,469			
	Accrued Depreciation	45,206			
	Net Plant 1/	416,263			
2.	Operating Expenses		45,767	40,110	36,017
3.	Interest Expenses 2/		28,967	28,863	28,788
4.	Debt Service Cost 3/		28,959	28,950	28,951

Source: F.E.R.C. Form P (now F.E.R.C. Form 6)

NOTE: All stated amounts are at issue before an F.E.R.C. Administrative Law Judge in the pending TAPS rate case, Docket No. OR78-1.

1/ Investment includes Construction Work In Progress

2/ Per Income Statement

3/ Includes Interest Costs

PHILLIPS ALASKA PIPELINE CORPORATION
Plant Investment, Operating & Interest Expenses, Debt Service Costs (000)

		1/1/80 $	1980 $	1981 $	1982 $
1.	Total Investment 1/	146,409			
	Accrued Depreciation	14,811			
	Net Plant 1/	131,598			
2.	Operating Expenses		13,353	11,555	9,958
3.	Interest Expenses 2/		10,066	10,027	9,997
4.	Debt Service Cost 3/		10,364	10,275	10,080

Source: F.E.R.C. Form P (now F.E.R.C. Form 6)

NOTE: All stated amounts are at issue before an F.E.R.C. Administrative Law Judge in the pending TAPS rate case, Docket No. OR78-1.

1/ Investment includes Construction Work In Progress

2/ Per Income Statement

3/ Includes Interest Costs

SOHIO PIPE LINE COMPANY
Plant Investment, Operating & Interest Expenses, Debt Service Costs
(000)

		1/1/80 $	1980 $	1981 $	1982 $
1.	Total Investment 1/	3,181,669			
	Accrued Depreciation	305,996			
	Net Plant 1/	2,875,673			
2.	Operating Expenses		299,052	285,032	269,707
3.	Interest Expenses 2/		239,655	227,137	215,508
4.	Debt Service Cost 3/		294,543	338,140	327,189

Source: Alaska Pipeline Commission Annual Report; Alaska Public Utility Commission Annual Report

NOTE: All stated amounts are at issue before an F.E.R.C. Administrative Law Judge in the pending TAPS rate case, Docket No. OR78-1.

1/ Investment includes Construction Work In Progress

2/ Per Income Statement

3/ Debt service costs were estimated from information contained in F.E.R.C. Form P (now F.E.R.C. Form 6) and/or Annual Reports filed with the Alaska Pipeline Commission or the Alaska Public Utility Commission.

UNION ALASKA PIPELINE COMPANY
Plant Investment, Operating & Interest Expenses, Debt Service Costs
(000)

		1/1/80 $	1980 $	1981 $	1982 $
1.	Total Investment 1/	146,106			
	Accrued Depreciation	14,009			
	Net Plant 1/	132,097			
2.	Operating Expenses		13,704	12,388	10,198
3.	Interest Expenses 2/		8,364	8,053	7,561
4.	Debt Service Cost 3/		8,331	13,689	13,260

Source: F.E.R.C. Form P (now F.E.R.C. Form 6)

NOTE: All stated amounts are at issue before an F.E.R.C. Administrative Law Judge in the pending TAPS rate case, Docket No. OR78-1.

1/ Investment includes Construction Work In Progress

2/ Per Income Statement

3/ Includes Interest Costs

ARCO PIPE LINE COMPANY
Rate of Return

IN Thousands

	Company Position	State of Alaska Position	FERC Staff Position
1980			
Revenues	$ 711,557	$ 711,557	$ 711,557
Operating Expenses	185,773	171,265	174,464
Income Taxes Claimed	208,632	15,314	40,628
Carrier Income	317,152	524,978	496,465
Rate Base Claimed	2,035,451	1,202,941	1,420,389
Rate of Return	15.58%	43.64%	34.95%
1981			
Revenues	$ 717,505	$ 717,505	$ 717,505
Operating Expenses	203,554	177,709	182,914
Income Taxes Claimed	245,953	22,091	38,086
Carrier Income	267,998	517,705	496,505
Rate Base Claimed	1,960,038	1,150,376	1,154,193
Rate of Return	16.67%	45.00%	36.66%
1982			
Revenues	N/A	$ 728,402	$ 728,402
Operating Expenses		158,433	162,663
Income Taxes Claimed		<8201>	22,148
Carrier Income		578,170	543,591
Rate Base Claimed		1,071,298	1,280,447
Rate of Return		53.97%	42.45%

BP PIPELINES, INC.
Rate of Return

	Company Position	State of Alaska Position	FERC Staff Position
1980			
Revenues	$ 556,820	$ 556,820	N/A
Operating Expenses	149,123	125,621	
Income Taxes Claimed	167,690	6,181	
Carrier Income	240,007	425,018	
Rate Base Claimed	607,086	906,169	
Rate of Return	14.93%	46.90%	
1981			
Revenues	$ 583,842	$ 583,842	N/A
Operating Expenses	152,891	131,395	
Income Taxes Claimed	188,605	14,702	
Carrier Income	242,346	437,745	
Rate Base Claimed	1,544,028	897,478	
Rate of Return	15.70%	48.78%	
1982			
Revenues	N/A	$ 587,752	N/A
Operating Expenses		115,635	
Income Taxes Claimed		<4372>	
Carrier Income		476,489	
Rate Base Claimed		838,220	
Rate of Return		56.85%	

EXXON PIPELINE COMPANY
Rate of Return

	Company Position	State of Alaska Position	FERC Staff Position
1980			
Revenues	$ 696,124	$ 696,124	$ 696,124
Operating Expenses	170,098	153,413	157,186
Income Taxes Claimed	217,946	28,426	51,262
Carrier Income	308,080	514,285	487,676
Rate Base Claimed	1,879,600	1,157,602	1,360,043
Rate of Return	16.39%	44.43%	35.86%
1981			
Revenues	$ 695,997	695,997	$ 695,997
Operating Expenses	175,465	157,051	161,701
Income Taxes Claimed	231,695	50,442	56,286
Carrier Income	288,846	488,504	478,010
Rate Base Claimed	1,842,510	$1,115,888	1,296,687
Rate of Return	15.68%	43.78%	36.86%
1982			
Revenues	$ 633,512	$ 633,512	$ 633,512
Operating Expenses	170,069	137,985	142,492
Income Taxes Claimed	215,950	15,883	36,711
Carrier Income	247,493	479,644	454,309
Rate Base Claimed	2,081,591	1,049,663	1,225,627
Rate of Return	11.89%	45.70%	37.07%

SOHIO PIPE LINE COMPANY
Rate of Return

	Company Position	State of Alaska Position	FERC Staff Position
1980			
Revenues	$1,130,970	$1,130,970	N/A
Operating Expenses	300,864	257,664	
Income Taxes Claimed	311,146	<3461>	
Carrier Income	518,960	876,767	
Rate Base Claimed	3,236,091	1,882,005	
Rate of Return	16.04%	46.59%	
1981			
Revenues	$1,128,837	$1,128.837	N/A
Operating Expenses	307,820	260,171	
Income Taxes Claimed	329,440	<1998>	
Carrier Income	491,577	870,664	
Rate Base Claimed	3,107,892	1,774,751	
Rate of Return	15.82%	49.06%	
1982			
Revenues	N/A	$1,240.846	N/A
Operating Expenses		227,218	
Income Taxes Claimed		<23810>	
Carrier Income		1,037,438	
Rate Base Caimed		1,666,484	
Rate of Return		62.25%	

TRANS ALASKA PIPELINE SYSTEM
Interstate Tariff Rates
(per barrel)

Owner Company	ICC Tariffs 1/	Piled Tariffs 2/
Amerada Hess Pipeline Corporation	$4.85	$6.44
ARCO Pipe Line Company 5/	4.91	6.04
BP Pipelines, Incorporated 5/	4.68	6.35/5.40 3/
Exxon Pipeline Company	5.10	6.27/5.30 4/
Mobil Alaska Pipeline Company	4.84	6.31
Phillips Alaska Pipeline Corporation	4.83	6.22
Sohio Pipe Line Company	4.70	6.16
Union Alaska Pipeline Company	4.89	6.09
Weighted average rate	4.84	6.20

1/ In effect from date of initial service to expiration of the ICC suspension period during January, 1978.

2/ In effect subsequent to the ICC suspension period.

3/ BP reduced its rate to $5.40 per barrel from July 1, 1982 to November 1, 1983.

4/ Exxon reduced its rate to $5.30 per barrel from January 1, 1982 to October 19, 1983.

5/ Exxon and BP levy a surcharge for oil originating in the Kuparuk reservoir.

BERKLEY BEDELL, IOWA
CHAIRMAN

NORMAN SISISKY, VA.
JIM COOPER, TENN.
JAMES R. "JIM" OLIN, VA.
RICHARD RAY, GA.
JOSEPH P. ADDABBO, N.Y.
HENRY B. GONZALEZ, TEX.
C. ROBIN BRITT, N.C.

United States House of Representatives
Committee on Small Business
Subcommittee on General Oversight and the Economy
B-363 Rayburn House Office Building
Washington, D.C. 20515

SILVIO O. CONTE, MASS.
SHERWOOD L. BOEHLERT, N.Y.
MICHAEL BILIRAKIS, FLA.
DAN SCHAEFER, COLO.

MAJORITY SUBCOMMITTEE STAFF
MARK J. LEVINE
CHARLES W. McMILLION
202-225-8944

MINORITY SUBCOMMITTEE COUNSEL
DONALD C. BERNO
202-226-3420

September 21, 1983

Hon. Charles M. Butler III
Chairman
Federal Energy Regulatory Commission
825 North Capitol Street, N.E.
Washington, D.C. 20426

Dear Chairman Butler:

On September 15, the Small Business Committee's Oversight Subcommittee held a hearing to explore allegations by independent gasoline marketers that some major integrated producers of Alaska North Slope (ANS) crude oil were underestimating the well-head value of their ANS crude by artificially inflating the costs of transporting the oil to the market. These marketers claim that this allows major integrated ANS crude oil producers to underpay their windfall profits tax by an amount large enough to significantly lower their retail gasoline prices and gain a substantial competitive advantage over other refiners and marketers who do not have access to ANS crude oil.

During the question and answer sessions with our witnesses, members of the Subcommittee were informed that the major owners of the trans-Alaska crude oil pipeline may be earning a rate of return far above the rate envisioned for conventional business investments on the oil that is transported through the pipeline. The suggestion was also made that improperly high per-barrel transportation rates on ANS crude oil shipped through the pipeline serve to reduce the appropriate windfall profits tax payments to the Federal Treasury. The independent marketers and refiners who testified before our panel were unanimous in their opinion that subsidies in the form of underpayments of windfall profits taxes stemming from the artificial inflation of transportation costs on ANS crude oil puts them at a competitive disadvantage in the gasoline marketplace.

Mr. Butler, a number of questions were raised during our September 15 hearing that we believe should be addressed by the Federal Energy Regulatory Commission. It would be helpful to our deliberations to have your office provide us with a history of the actions taken by FERC, its predecessor agencies, and the courts to regulate transportation rates on the trans-Alaska crude oil pipeline.

Included in that history it would be helpful to have a brief summary of the amounts invested in the pipeline by the individual owners as of January 1, 1980. We would also like a breakdown of the current operating expenses, including the costs of interest and debt service incurred by the owners of the pipeline in the past three years. We would further like the Commission to provide us with a history of the rates of return earned on the pipeline by the 5 largest owners in the individual years since decontrol.

The Subcommittee would also like to know if the rates currently being charged by the pipeline owners are FERC-approved, and if the Commission has future plans to review these rates. Finally, does FERC have jurisdiction to set and regulate the transportation rates on ANS crude oil that is shipped by tanker between U.S. ports? If not, who does?

Mr. Butler, after reviewing the requested information, the Oversight Subcommittee would like to schedule a meeting with your office to discuss this matter further. Accordingly, it would be appreciated if your office could supply us with the requested information in two weeks.

If you have any questions about this request, please contact Mark Levine of the Oversight Subcommittee staff, at 225-8944.

Sincerely,

Berkley Bedell
Berkley Bedell
Chairman

Richard Ray
Richard Ray

Robin Britt
Robir Britt

Norman Sisisky
Norman Sisisky

Silvio O. Conte
Silvio Conte
Ranking Member

Michael Bilirakis
Michael Bilirakis

Sherry Boehlert
Sherwood Boehlert

Dan Schaefer
Dan Schaeffer

Mr. ALBOSTA. Please proceed.

TESTIMONY OF HON. BERKLEY BEDELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Mr. BEDELL. Thank you, Mr. Chairman. I want to commend you very, much for holding these hearings. It is my opinion that if we could expose what is really happening as far as pipeline charges are concerned, and American people knew it, they would rise up in anger and demand that something be done.

Almost by accident, my subcommittee became involved in this issue. Through my subcommittee's investigation it became obvious that many of our small business distributors of petroleum products were unable to meet the prices Atlantic Richfield Co. was charging for their products. As we looked into it, we found that independent competitors alleged Arco was underpaying their windfall profit tax by some $200 million per year.

The value of Alaska North Slope crude at the wellhead for windfall profits tax purposes is determined by the market price in the nearest market minus the cost of transporting the oil from the wellhead to that market. Other producers in the lower 48 States use the market price determined at the wellhead. Arco petroleum ships most of its ANS crude oil to California, but has been computing the wellhead value as if all of the oil went to Texas, since transportation costs to Texas are much greater than to California. A new ruling by the Treasury Department which came about as a result of my subcommittee's actions, denies them permission to incorporate these transportation charges into the marketplace for windfall profits tax purposes.

But there are still two big loopholes in the computation for windfall profits taxes on North Slope oil.

Treasury Department revenue ruling 75-483 allows these shippers to claim as foreign source income the earnings they derive from transporting Alaskan oil outside of U.S. territorial waters. What these shippers do, and Arco is one of them, is leave Alaskan ports, cruise just outside of U.S. territorial waters for most of their journey, and then cut back in and deliver their cargo to another U.S. port.

Remember, you cannot by law export Alaskan oil. And anything shipped between American ports must be on American-built and manned ships. Let me explain this in complete detail, Mr. Chairman.

The IRS has ruled that if these oil companies will transport their oil outside the territorial waters from the Alaska port to California, it will not be considered domestic transaction. It will not be subject to domestic income taxes for the income earned when they get outside of those territorial waters. So they are transporting oil from a domestic port in Valdez, Alaska, to California and calling it a foreign operation, and do not have to pay domestic income taxes on that part of the journey.

Since they have large foreign tax credits, some of them are not having to pay any taxes on the income earned by shipping the oil. Also, remember that since the value of the crude oil at the wellhead is determined by the market price less transportation, and since there is a 70-percent windfall profits tax, every dollar extra that they charge themselves on that transportation saves them 70 cents in taxes that would otherwise be due to the U.S. Government as taxable income.

This brings me to the pipeline problem which this committee is considering. Attached to this testimony is a letter received by my subcommittee dated October 19, 1983, from the Federal Energy Regulatory Commission. Schedule B attached to this letter shows that Arco Pipe Line Co. listed their rate of return on investment in 1980 as 15.58 percent, whereas the State of Alaska computes their rate of return at 43.64 percent per year, and the FERC staff computes annual rate of return at 34.95 per year.

According to FERC, which is supposed to regulate pipeline charges, current charges enable the Trans Alaska Pipeline owners to pay for its investment every 3 years. However, FERC has not regulated the rates. They have been holding hearings since October 1, 1977—6 years—and their letter indicates that they still plan another year of hearings. Mr. Chairman, if this is not intentional collusion, it is inexcusable bureaucratic ineptitude.

I am not an expert in this area, but it seems to me that it should not take 10 minutes to rule on the ridiculousness of some of the things the pipeline companies are trying to get away with.

If you are in business and build a building, or buy a piece of machinery, you are permitted to depreciate the asset over a given period of time. If you have an investment of $100 depreciated over a 20-year period, with straight-line depreciation, you would deduct $5 per year for depreciation, and after 1 year the book value of your asset would be $95.

But that is not what the pipelines are doing. They take the $5 depreciation, and then turn around and appreciate the $95 asset because of inflation and other factors so that the book value may actually be increased to more than its original value.

This procedure enables the pipeline companies to escalate their equity and therefore justify higher tariffs and profits.

It shouldn't take FERC 10 minutes to rule that this is improper.

When I pay my Federal income tax, I can deduct some of the other taxes I actually pay. The pipeline companies don't do this. They don't deduct the taxes paid in deriving income for computing their rate of return. They deduct the taxes from the tax table, rather than the taxes paid. Let me repeat that, Mr. Chairman. They don't deduct the taxes paid. They deduct what the tax tables show could have been paid. Try doing that on your tax return, Mr. Chairman.

It shouldn't take FERC 1 minute to rule on this matter.

Finally, if you are a pipeline company and want to build a billion dollar pipeline, you might put up $100 million and borrow $900 million. Your equity is $100 million. But some pipeline companies compute their return not on equity, but on investment. If they were to receive a 10-percent rate of return on investment, which is less than what any of the oil companies themselves computed on the attached list, they would receive $100 million per year, which is a 100-percent return on investment. Do you think it should take FERC 7 years to decide whether or not a 100-percent return on equity per year is excessive?

The Oversight Subcommittee is very concerned about this situation. Besides being a huge drain on our Treasury, these actions can also have an adverse impact on downstream gasoline marketing activities. Imagine being in a market where your competitors can use the Tax Code to pay less in taxes per unit sales than you do. We, as a panel, plan to pursue this situation further.

Mr. Chairman, the purpose of these hearings is whether or not pipeline companies should be decontrolled. I suggest that that is not the proper question. Mr. Chairman, I don't know what the connection is between pipeline companies and FERC, but it is apparent to me that for all practical purposes there is no effective control of pipeline charges at this time.

I suggest that the question you should be asking is whether or not there should be control over pipeline charges, and whether there are any improper connections between FERC and oil and pipeline companies. Seems to me that, if anything, this information should prove that we cannot decontrol pipeline companies. For Heaven's sakes, if they can get profits under controls such as we have now, with rulings such as we have now, surely there cannot be any competition, because surely competition would not permit this.

If they do this under controls, what would they do under decontrol, Mr. Chairman?

[At this point, Mr. Anderson, chairman of the subcommittee, assumed the chair.]

Mr. ANDERSON. Well, thank you, Congressman Bedell for an excellent statement. It sounds in your presentation, however, that you made a pretty good argument for decontrol if it is as bad as that under control.

Mr. BEDELL. Mr. Chairman, I agree, it couldn't be very much worse.

Mr. ANDERSON. I take it from your testimony that you believe the subcommittee should hold oversight hearings, extensive oversight hearings on the Federal Energy Regulatory Commission and how they are regulating the oil pipeline industry. Is that the point of what you are suggesting?

Mr. BEDELL. I sure do, Mr. Chairman.

Mr. ANDERSON. Many things you have mentioned have not been brought out, as far as I am concerned, before.

Mr. BEDELL. That is why I was so anxious to be here, Mr. Chairman. I should tell you that we have had some letters from some of the people concerned over the information we have submitted to you from FERC. This is a letter we received from FERC.

Mr. ANDERSON. When you say "we"——

Mr. BEDELL. My subcommittee. My subcommittee got involved somewhat by accident in that I am chairman of the Small Business Subcommittee on General Oversight, and the Economy. Many small businesses have been severely impacted by the pricing policies of Atlantic Richfield. As we looked into it, we found that Atlantic Richfield was avoiding, I think that is the right word, paying taxes equivalent to what has been estimated at some $200 million per year. This was due to the lack of clarity of the revenue ruling regarding the calculation of ANS crude oil prices. Because of the work of my subcommittee that situation has been changed. The

Treasury ruling has been correctly defined so that ARCO must pay the proper taxes. That is how we got into this whole issue.

If I could take a minute, I should bring to your attention a letter we have received in regard to this information. I urge you to read it. It contains FERC's information with regard to pipeline profits. If you want to turn to schedule B, page 1 of 4 you will notice a big difference in the income taxes claimed.

As I mentioned earlier in my testimony, $280 million is not what ARCO paid, it is what they claimed they could have paid if, they had calculated their taxes according to tax tables.

Mr. **Albosta**. What was the number of that page?

Mr. **Bedell**. Schedule B.

Mr. **Anderson**. Page 1 of 4?

Mr. **Bedell**. Yes. There are several pages. I don't mean to pick on ARCO. They are all similar. But it is the first one listed here. FERC wanted to point out that in the State of Alaska, where it shows 15 million taxes paid, that is what the State of Alaska computed ARCO would have paid in taxes if the pipeline charges had been what they should have been, which is a lower charge. So the 15 million is actually too low in fairness. However, if you triple that, it would still leave a profit of something on the order of 35 percent or so per year.

I think many of us would feel that would be excessive. And, remember, that is the profit not on their equity, that is the profit on the rate base, which is the value they claim for the pipeline at that time rather than the return on equity.

Mr. **Anderson**. Just going through this 1981 figure, on the rate base claim, could you tell me really the difference between those three figures? The first is the staff position, 154,000. Second is the State of Alaska position, 1,150,000. Third was the company position, one million nine hundred—what do those three——

Mr. **Bedell**. There is a misprint. It should be 1,154 million for the FERC staff position.

Mr. **Anderson**. Are these millions or billions?

Mr. **Bedell**. The first figure is in billion, $1,960 million. But this illustrates the problem, Mr. Chairman. You see, when they compute their return on your rate base, they are permitted to constantly escalate the value of their investment rather than depreciate the value of their investment. You can see the difference in the rate base that is claimed here. That is how they are able to get a significantly lower return.

But even if you tell them that they don't have to depreciate their assets, as almost any business would have to do, they would still get a 16 percent profit. If I buy a machine for a $100 and depreciate it over a 10-year period, after 5 years it is only worth $50.

But that is not what the pipeline companies do. They buy it for $100 and depreciate it $50. But they say because of the improvement in value of the pipeline, and because of inflation and all those sorts of things, we are going to increase the value of that $100 investment. Instead of it only being worth $50, we are going to say it is worth $150 today and we are going to claim that we should get return on the $150. Do you follow me?

Mr. **Anderson**. Yes.

Mr. BEDELL. You sure wouldn't be permitted to do that in any other cases I know of. That all goes towards equity. So what they are doing is they are increasing their equity by escalating the value of something they depreciate. So instead of having it depreciate so it isn't worth anything in 20 years, its worth is more and more. In 20 years they have taken off their depreciation and increased the value.

Mr. ALBOSTA. Would the chairman yield?

Mr. ANDERSON. Let me get Mr. Smith first.

Mr. SMITH. Thank you, Mr. Chairman.

Congressman, thank you for your statement. There are some interesting questions you raise. Justice Department has testified before this committee that, in their opinion, roughly two-thirds of the pipelines could be decontrolled and still have competition equivalence. Roughly one-third of them they say are in a monopoly situation. Obviously, FERC, having to look at all pipelines, I am sure they would testify they are overburdened. Would it not follow that if we could identify those pipelines that were in a competitive position, that the remainder would be under scrutiny of FERC, and probably we could do a lot better job of managing the bureaucracy as well as those pipelines that were in a monopoly position?

Mr. BEDELL. If you could show that. And I do not have that knowledge, Mr. Smith. I have to tell you that I question whether FERC wants to regulate the pipelines. Can you believe that it would take 6 years, after what I have told you, with 70-cent loss of revenue to the U.S Treasury for every dollar that we lose here in terms of income? Can you believe that they would take 6 years and say it is still going to take another year to investigate it before they say these things I have pointed out are incorrect?

Mr. SMITH. Maybe we ought to be talking with FERC about it.

Mr. BEDELL. I think you should. And we plan to talk to FERC.

Mr. SMITH. You and I shouldn't have to identify those pipelines, either. The Department of Justice testified that they could identify those pipelines. It just occurred to me that, if you had only one-third left, you could do a much better job of identifying them.

Mr. BEDELL. I do not disagree with that. If FERC would submit that information, I would like to have some committee staff look at it.

Mr. SMITH. Absolutely.

Mr. BEDELL. FERC should find out whether their return on equity is similar to what you might expect in some other business.

To say you can make 100 percent on equity per year tells me there isn't any competition. I know of no competitive industry where you could expect to make 100 percent on your investment every year. Do you?

Mr. SMITH. No, I don't. And I guess there are, what, 83 pipelines? There are several.

Mr. BEDELL. Sure. It is a good point.

Mr. SMITH. So you know, this may be one. We would have to look at every company to determine that, of course.

Thank you very much.

Mr. BEDELL. Sure.

Mr. ANDERSON. Mr. Albosta.

Mr. ALBOSTA. Thank you, Mr. Chairman. I want to commend the gentleman from Iowa for his excellent work, testimony, and the work your subcommittee has done and pointing out some what I believe are real problems that we face, not only with the problem of deregulation, and what we are going to do with the gas pipeline industry, but what is going on with the IRS that we would allow them to add on value through appreciation to a pipeline, and then depreciate it.

Mr. BEDELL. Yes.

Mr. ALBOSTA. Did you check with the tax code to find out how they do that, or is that just an arbitrary position they take, or what?

Mr. BEDELL. Well, I can only tell you my impression. I am not a specialist on this. You are going to be hearing testimony from other people. My impression is that when you get enough high-priced lawyers involved in all these things, they question everything and argue back and forth, and get it into the courts and fuss about it for a long, long time as to these practices, what is right and wrong in these practices.

I can tell you that in my opinion, the Treasury has been most cooperative with my subcommittee. We brought to their attention the problem with ARCO, and although it didn't happen as quickly as I thought it should have, it happened in weeks, not in years, that they came through with a new revenue ruling.

When I talked to the people over at Treasury about the ruling that now exists, which says that transportation from Valdez to California will not be subject to domestic income taxes, the person I talked to there was shocked to find that the case, and indicated that he would look into the matter. So my impression is that as we bring these issues to them, they have been cooperative with our committee and reasonable in what they have done.

We have not yet met with FERC. They have sent us this letter, which I think is pretty revealing, frankly. We want to meet with them and talk with them. I cannot imagine them sitting there for 6 years on an issue of that magnitude. My understanding is that the GAO has estimated that we are losing somewhere between $500 and $800 million per year in Alaska North Shore crude oil windfall profit taxes. That is not published yet, but that is the rumor, and it is not exactly peanuts.

Mr. ALBOSTA. That was one of the questions that I was going to ask you about the GAO report that is due next month. Have you seen the preliminary report?

Mr. BEDELL. No.

Mr. ALBOSTA. Parts of that report?

Mr. BEDELL. I have only heard reports of it.

Mr. ALBOSTA. It would seem that the General Accounting Office should be able to shed some light when the final report comes out on at least that part of it that they are investigating.

Mr. BEDELL. Mr. Chairman, I commend you so much for these hearings. And if in your hearings anything comes out that would indicate any significant discrepancies from the testimony I have given here, I would appreciate it if your staff would check with our staff. It seems to me we need to get to the bottom of these things, find out what the reality is. I am not interested in excuses as to why they think it is all right to make a 100-percent return if that is what they are placing on their investments.

I am interested in any testimony that indicates in any way that the statements I have made here are subject to any debate.

Mr. ANDERSON. Very good, Congressman. Excellent statement.

Mr. BEDELL. Thank you.

Mr. ANDERSON. Our next witness is Mr. Tom Hunter, director, crude supply and planning, Farmland Industries, and Mr. Joe Crites, assistant counsel, Farmland Industries.

Mr. Hunter, we do have your prepared statement. It will be made a matter of the record in its entirety at this point.

[Statement referred to follows:]

TESTIMONY OF THOMAS HUNTER, DIRECTOR, CRUDE SUPPLY AND PLANNING FARMLAND INDUSTRIES, INC.

Mr. Chairman, members of the committee, my name is Tom Hunter, director, Crude Supply and Planning, Farmland Industries, Inc., Kansas City, Missouri. My background includes working for a major common carrier pipeline company for four years before I became associated with Farmland Industries over nine years ago. I wish to thank you for the opportunity to express Farmland's continuing opposition to the removal of rate control authority on petroleum pipelines.

Let's explore the reasons Farmland is opposing H.R. 2677 and why this proposal adversely affects agriculture.

AGRICULTURAL PERSPECTIVE

Farmland Industries is an agricultural cooperative, owned by 2,300 local cooperative associations in 19 Midwestern states. Through these local associations, Farmland supplies 500,000 farmer owner/members with fertilizer, agricultural chemicals, petroleum products, feeds, equipment, and supplies. Farmland Industries, Inc., owns two operating refineries at Coffeyville, Kansas (capacity 60,000 barrels per day), and Phillipsburg, Kansas (capacity 8,000 barrels per day).

The primary purpose of our refining system is to serve the needs of local member/owner associations of Farmland Industries and, in turn, the farmers and ranchers who are members of these local cooperatives.

An unjustified increase in the cost of inputs for agricultural production, such as petroleum products, is of great concern to Farmland and the 500,000 agricultural producers we serve.

Energy costs are a significant percentage of the total production cost of many foods. For example, in late 1981, energy costs were over 22 percent of the farm price of a bushel of corn. It requires a great deal of energy from petroleum products to produce the food which we are so used to having in bountiful supply. Even a relatively small increase in the price of petroleum products translates into large dollar cost increases for the farmers and ranchers.

REGULATORY PERSPECTIVE

Farmland does not believe that pipeline rate regulations need be unduly burdensome or costly. Our own experience with the application of existing regulations has been something less than satisfactory. For example, we have been involved in a rate proceeding (Docket No. OR79-1, et al., Williams Pipe Line Company) concerning petroleum product shipments on the Williams Pipe Line since 1971.

Initially, a shippers group, including Farmland Industries, filed a complaint with the ICC, challenging certain pipeline tariffs. The record of this case is both long and voluminous. On November 30, 1982, some 11 years later, FERC issued its decision in Phase I of the Williams case and that decision is now on appeal before the Circuit Court of Appeals for the D.C. Circuit. Phase II deals with the application of the Commission's opinion to Williams published rates. Because of this regulatory experience, we would agree regulatory reform is appropriate and long overdue.

The need to improve regulation of pipeline transportation is also suggested by events described in the Oil Daily on October 31, 1983. Even under present regulation, the FERC computed rates of return of over 30 percent for the four major owners of the Trans-Alaska Oil Pipeline in 1980 and 1981. The state of Alaska computed rates of return of approximately 40 percent while the companies claimed rates of return in the 15–17 percent range.

Farmland's agricultural and regulatory experiences provide a unique backdrop for our involvement in H.R. 2677. I will now address several significant issues which are continually debated during the course of any discussion of pipeline deregulation.

I. Issue

Does competition exist between pipeline companies today?

A study titled "Competition in Oil Pipeline Markets: A Structural Analysis," coauthored by Robert E. Anderson and Richard Rapp of the National Economic Research Associates, Inc. (NERA), answers this question. The study concludes that the majority of markets are uncompetitive. Some of the reasons are:

Barriers to entry.—Barriers to entry in oil pipeline markets are formidable, but not absolute. The most important barrier to entry is the presence of large economies of scale in pipeline construction and operation. The pipeline construction and operating cost per barrel of thruput is proportionately less for a large diameter pipeline than for small diameter pipeline. Thus, to avoid a cost disadvantage, a firm thinking of building a new pipeline to serve a particular market must be able to capture a share of the market comparable to the shares of existing competitors in that market. If the capacity of the new pipeline or its thruput is much less than that of existing pipelines, its unit cost of transportation will be relatively high. In simple terms, a small competitor will have a hard time competing with a large competitor in a pipeline market. More so than in many other industrial markets, new rivals in pipeline markets must be large compared to existing rivals to be successful.

Concentration of ownership.—Pipelines owned by the 18 major integrated oil companies transport almost 80 percent of the crude and product moved by pipeline. Not only do the major oil companies own most of the oil pipelines, but a large number are owned jointly by groups of oil companies as shown in the following table:

TABLE I.—SHIPMENT SHARES BY TYPE OF OWNER, 1981

Type of owner	Number of pipelines [2]	Share of barrel-mile throughout [1] (percent)		
		Crude	Product	Combined
	(1)	(2)	(3)	(4)
Major oil company [3]	58	77	81	79
Nonmajor oil company	26	4	1	2
Other company	25	19	18	19
Total	109	100	100	100

[1] Includes throughput of undivided interest systems.

[2] Companies that did not report throughput data are excluded from tally.

[3] Majors are considered to be the top 18 oil companies, namely: Amerada Hess Corp., Ashland Oil, Inc., Atlantic Richfield Co., Cities Service Co., Conoco, Inc., Exxon Corp., Getty Oil Co., Gulf Oil Corp., Marathon Oil Co., Mobil Oil Corp., Phillips Petroleum Co., Shell Oil Co., Standard Oil Co. of California, Standard Oil Co. of Indiana, Standard Oil Co., of Ohio, Sun Oil Co., Texaco, Inc., and Union Oil Co. of California. A joint venture pipeline is considered to be owned by major oil companies if major oil companies have a majority interest in the pipeline.

Source: "Liquid Pipelines," Oil and Gas Journal, vol. 80, No. 47, November 22, 1982, pp. 100–104.

Specifically, with regard to Farmland Industries, it is unreasonable and not economically feasible for Farmland to build or purchase a pipeline that would have substantial effect on its overall transportation requirements. We simply are not in a position to replace any substantial part of the existing pipelines we use with our own pipeline system. In addition to the above restrictions, a pipeline sized to meet only our requirements in our marketing area would not be big enough to provide the economies of scale, which are characteristic of larger pipelines and which are enjoyed by the pipeline companies Farmland currently utilizes. Without such comparable economies of scale, a Farmland Industries pipeline would not compete with an existing pipeline. Furthermore, the efficiencies of the economice of scale would be lost to farmers and ranchers served by our members and would be lost to the economy as a whole.

II. Issue

Do other forms of effective competition exist? Are they more costly?

Authors of some empirical studies have suggested that there is no need for concern about excessive pipeline rates—that "intermodal and intramodal" competition will determine rates—that free market factors wil keep rates at reasonable levels.

Water transportation.—There have been numerous remarks about competition from water carriers. Barge transportation is, with rare exception, nonexistent west of the Mississippi (excluding the West Coast) and certainly does not influence pipeline rates for petroleum products shipped in the Midwest.

The NERA study, accurately describes how the use of gross statistics overstates the importance of water transportation.

Aggregate statistics on movement of petroleum by various transportation modes exaggerate the importance of water transportation. A large share of the crude oil moved by water transportation is Alaskan crude, which has no alternative means to reach markets. Moreover, much of the oil product moved by water transportation consists of the "heavy ends" of the refinery runs, primarily residual fuel oil, which cannot be transportation by pipeline. For the crude and product that can be moved by pipeline, the vast majority is moved by pipeline—not water transportation.

The second reason competition from water carriers has been overestimated is that rivers and coastlines rarely follow straight lines. Rate comparisons between water carriers and oil pipelines in the past have not adequately reflected the much greater distance between origin and destination that oil transported on a barge or tanker must travel, compared to oil in a pipeline. Water carriers usually must follow circuitous routes that are much longer than the almost-straight-line paths traced by pipelines. Even through the rate per mile to move a barrel of oil might be about the same for a pipeline and barge, the total cost of movement from origin to destination is likely to be much higher over water because of the greater distance a barge has to travel.

Based on a study of barge rates done by the U.S. Army Corps of Engineers and on NERA's analysis of pipeline rates, NERA concludes that in most cases, transportation by barge is substantially more costly than by pipeline. If pipelines face competition only from barge transportation, most oil pipelines, except for very small diameter lines, could raise rates substantially in the absence of regulation without fear that shippers would switch to water transportation. Oil pipelines do compete with tankers in one major market: the movement of refined products from the gulf to the East Coast. The major pipeline serving this market is The Colonial Pipeline system. This large pipeline states that its rates are much lower than tankers rates. In 1980 and 1981, Colonial's rates were at least 50% lower than tanker rates.

III. Issue

Are pipeline transportation costs de minimus?

Farmland spent over $40 million in pipeline transportation cost last year; $15.8 million was paid to various companies supplying crude oil for our Coffeyville refinery. We do own our own crude oil gathering lines, as well as some short pipelines that connect major common carrier crude oil pipelines to our refineries. These larger pipelines are generally owned by other oil companies who are competitors in purchasing crude oil from crude producers, as well as in selling petroleum products in the marketplace.

Farmland owns no petroleum products pipelines. During our 1984 fiscal year, we are budgeting close to $20 million for pipeline transportation costs over four products pipeline systems. These include Sun Pipe Line, Williams Pipe Line, Kaneb Pipeline, and MAPCO Pipeline. Obviously, even a small percentage increase in pipeline tariffs translates into large dollar numbers, which ultimately farmers and ranchers have to pay.

Proponents of pipeline deregulation have argued that pipeline transportation costs are a relatively small percentage of the total cost. If pipeline tariffs represent 4 percent to 5 percent of the delivered price of petroleum products, this equates to at least $7 billion annually.

In 1981, the industry realized net income of about $2 billion, while charging its users $6.7 billion. 1981 TAPS revenues (still limited by the consent decree) were $3.5 billion for a project that cost about $9.5 billion to build and had less than $200 million in annual operating cost. Farmland very strongly disagrees with characterizing these numbers as de minimus. They are real costs that significantly impact farmers and ranchers and, ultimately, any consumer.

In summary, the absolute cost of pipeline transportation is high and getting higher. Competition from other transportation modes is limited, and competition between pipeline companies in certain geographical areas is also limited for several reasons. We support the basic conclusions found in the NERA study.

These conclusions all suggest that competition is ineffective in many oil pipeline markets. In the absence of regulation, many, if not most, oil pipelines would have substantial market power and would be able to charge higher and higher rates and earn substantial monopoly profits.

I appreciate the opportunity you have provided me to share with you some of Farmland's concerns and the concerns of the farmers and ranchers who own Farmland Industries. We think other consumers have the same kind of concerns that agricultural producers have. Most of all, we hope that you understand why it is imperative that protection be provided to pipeline shippers through effective regulatory controls. Farmland supports positions that would provide "just and reasonable" pipeline rates and does not support pipeline tariff decontrol which will undoubtedly lead to higher energy costs.

Mr. ANDERSON. Please proceed.

TESTIMONY OF TOM HUNTER, DIRECTOR, CRUDE SUPPLY AND PLANNING, FARMLAND INDUSTRIES; JOE CRITES, ASSISTANT COUNSEL, FARMLAND INDUSTRIES

Mr. HUNTER. Thank you, Mr. Chairman. Members of the committee, my name is Tom Hunter, director, crude supply and planning, Farmland Industries, Inc., Kansas City, Mo. I wish to thank you for the opportunity to express Farmland's continuing opposition to the removal of rate control authority on petroleum pipelines.

Let us explore the reasons Farmland is opposing H.R. 2677 and why this proposal adversely affects agriculture.

Farmland Industries is an agricultural cooperative, owned by 2,300 local cooperative associations in 19 Midwestern States. Through these local associations, Farmland supplies 500,000 farmer owner/members with fertilizer, agricultural chemicals, petroleum products, feed, equipment, and supplies. Farmland Industries, Inc., owns two operating refineries at Coffeyville, Kans.—capacity 60,000 barrels per day—and Phillipsburg, Kans.—capacity 8,000 barrels per day.

The primary purpose of our refining system is to serve the needs of local member/owner associations of Farmland Industries and, in turn, the farmers and ranchers who are members of these local cooperatives.

An unjustified increase in the cost of inputs for agricultural production, such as petroleum products, is of great concern to Farmland and the 500,000 agricultural producers we serve.

We believe Farmland has a great perspective to pipeline deregulation and H.R. 2677 and we are here today to comment from that perspective. It involves a regulatory perspective and the agricultural perspective which I just mentioned. Farmland does not believe that pipeline rate regulations need be unduly burdensome or costly. Our own experience with the application of existing regulations has been something less than satisfactory. For example, we have been involved in a rate proceeding concerning petroleum product shipments on the Williams Pipe Line since 1971.

Initially, a shippers group, including Farmland Industries, filed a complaint with the ICC, challenging certain pipeline tariffs. The record of this case is both long and voluminous. It was mentioned several times yesterday.

Recently, on November 30, 1982, some 11 years later, FERC issued its decision in Phase I of the Williams case and that decision is now on appeal before the Circuit Court of Appeals for the D.C. Circuit. Phase II deals with the application of the Commission's opinion to Williams published rates. Because of this regulatory perspective, we would agree regulatory reform is appropriate and long overdue.

There are certain issues we believe are regularly debated and discussed and we would like to speak to several of those issues today. The first one mentioned yesterday and will be talked about again today is the issue of competition, Mr. Chairman, and whether it exists or doesn't exist between pipeline companies today. A study entitled competition in oil pipeline markets, a structural analysis, attempts to answer these questions.

In this study conducted by NERA it concluded that the majority of the pipeline markets that this study studied are basically uncompetitive. They talked about several reasons, and I have given you some quotes in my written statement I will paraphrase today. Talked about the barriers to entry and how high they are, large economies of scale enjoyed by existing pipelines, and it talked about concentration of pipeline ownership. All reasons to demonstrate the lack of competition today.

Eighteen major integrated oil companies transport almost 80 percent of the crude and product moved by pipeline. Not only do the major companies own most of the large pipelines but a large number are owned jointly by groups of oil companies as shown in the table by my written statement. Farmland's own experiences in shipping both crude oil and petroleum products in the midcontinent area for the last 40 years would really support NERA's conclusions.

We are a captive shipper on certain petroleum product pipelines. Even our refinery at Coffeyville is captive to a crude oil system that supplies well over 60 percent of its total needs. It is unreasoanble and basically not economically feasible for Farmland to build or even purchase a pipeline that would have a substantial effect on its overall transportation requirements. We simply are not in a position to replace any substantial part of the existing pipelines we use with our own system.

In addition to the above restrictions a pipeline sized to meet only our requirements in our marketing area would not be big enough to provide the economies of scale which are characteristic of larger pipelines and which are enjoyed by the pipeline companies Farmland currently utilize. Without such comparable economies of scale a Farmland Industry's pipeline would not compete with an existing pipeline.

Furthermore, the efficiencies of the economies of scale would be loss to farmers and ranchers served by our members and would be lost to the economy as a whole. The second issue we wish to address and which was also talked about yesterday is the issue of othe forms of effective competition.

Authors of some empirical studies have suggested that there is no need for concern about excessive pipeline rates—that "intermodal and intramodal" competition will determine rates—that free market factors will keep rates at reasonable levels.

Once again turning basically to the midcontinent region of the United States with which we are most familiar, we find the facts are that basically that barge transportation is with very rare exception nonexistent west of the Mississippi, excludng maybe the west coast, and certainly does not influence any, or many pipeline rates for petroleum products shipped in the Midwest.

In fact, many of the navigable waterways in our region are frozen over in December, January, February, and March. We find as NERA has concluded that gross statistics really overstate the importance of water transportation. Quoting from the study just briefly, a large share of the crude oil moved by water transportation is Alaskan crude, which has no alternative means to reach markets. Moreover, much of the oil product moved by water transportation consists of the heavy ends of the refinery runs, primarily residual fuel oil, which cannot be transported by pipeline. For the crude and product that can be moved by pipeline, the vast majority is moved by pipeline—not water transportation.

NERA goes on to talk about ton miles, which I urge you understand, showing that water carriers generally do not follow straight paths as pipelines do. They follow very circuitous routes. Even though the rate per mile to move a barrel of oil might be about the same for a pipeline and barge, the total cost of movement from origin to destination is likely to be much higher over water because of the greater distance a barge has to travel. So they have concluced, and we would agree to that, that transportation by barge is substantially more costly than by pipeline.

If pipelines face competition only from barge transportation, most oil pipelines, except for very small diameter lines, could raise rates substantially in the absence of regulation without fear that shippers would switch to water transportation.

Another issue is that of truck transportation. We feel uniquely suited to comment on that because we found out our own trucks are not competitive in our crude oil gathering systems. One instance I am very familiar with and what you would define I think as a crude collection market, we found we could build a gathering line and run our own truck out of business even though the truck was only transporting the least crude nine miles.

Pipelines are just very efficient, very effective and efficient forms of transportation. Trucks are not. For any kind of large volume over any kind of distance whatsoever. Maybe in a very small radius as was mentioned yesterday they are fairly effective. But not to move the vast majority of petroleum products throughout the United States or at least in the midcontinent region that we are familiar with.

The last issue I want to talk about is really the issue of absolute cost. I guess Farmland has over the years been characterized as bringing this issue to the forefront. Our opponents have said that you shouldn't worry about it, Farmland. The cost is de minimis and submicroscopic I think are two words that are basically used.

Let me tell you what de minimis and submicroscopic mean to an agricultural cooperative. Farmland spent over $40 million in pipeline transportation cost last year; $15.8 million was paid to various companies supplying crude oil for our Coffeyville refinery. We do own our own crude oil gathering lines, as well as some short pipelines that connect major common carrier crude oil pipelines to our refineries. These larger pipelines are generally owned by other oil companies who are competitors in purchasing crude oil from crude producers, as well as in selling petroleum products in the marketplace.

Farmland owns no petroleum products pipelines. During our 1984 fiscal year, we are budgeting close to $20 million for pipeline transportation costs over four products pipeline systems. Obviously, even a small percentage increase in pipeline tariffs translates into large dollar numbers, which ultimately farmers and ranchers have to pay.

Yesterday, for instance, we talked briefly about what pipeline deregulation might mean in terms of cents per gallon. If I remember the testimony correctly, Mr. Chairman, we talked about a penny a gallon in some testimony. And we talked of petroleum demand in the United States, some 15 million barrels a day. Obviously this is not all moved by pipeline. But if it were, that translates into well over $2 billion a year when you multiply the barrels times the gallons times the penny. To the extent that that is owned by pipeline that will be an extra revenue to the pipeline companies and undoubtedly an extra cost to consumers.

So we don't understand why proponents of pipeline deregulation have argued that pipeline transportation costs are a relatively small percentage of the total cost. If pipeline tariffs represent 4 to 5 percent of the delivered price of petroleum products, this equates to at least $7 billion annually.

In 1981, the industry realized net income of about $2 billion, while charging its users $6.7 billion. 1981 TAPS revenues—still limited by the consent decree—were $3.5 billion for a project that cost about $9.5 billion to build and had less than $200 million in annual operating cost. Farmland very strongly disagrees with characterizing these numbers as de minimis or submicroscopic. They are real costs that significantly impact farmers and ranchers and, ultimately, any consumer.

Mr. Chairman, we have outlined the situation today, and basically about out situation in the midcontinent region. If anything, I was very interested to hear the testimony yesterday from Mr. Baxter. This competition I feel is decreasing due to several refinery closings that are going on. Kansas City alone, we have had the only two refineries closed, over 200,000 barrels a day of capacity shut down. Augusta, Kans., Enid, Okla., and Scott's Bluff Refinery, our refinery at Phillipsburg, closed for about 15 minutes.

Competition in this area of the country is certainly getting less and less. Dependence on the importance of moving petroleum products into the region via major petroleum products-type lines has increased.

So in summary, the absolute cost of pipeline transportation is high and getting higher. Competition from other transportation modes is limited, and competition between pipeline companies in certain geographical areas is also limited for several reasons. We support the basic conclusions found in the NERA study.

These conclusions all suggest that competition is ineffective in many oil pipeline markets. In the absence of regulation, many, if not most, oil pipelines would have substantial market power and would be able to charge higher and higher rates and earn substantial monopoly profits.

I appreciate the opportunity you have provided me to share with you some of Farmland's concerns and the concerns of the farmers and ranchers who own our company. We think other consumers have the same kind of concerns that agricultural producers have. Most of all, we hope that you understand why it is imperative that protection be provided to pipeline shippers through effective regulatory controls. Farmland supports positions that would provide "just and reasonable" pipeline rates and does not support pipeline tariff decontrol which will undoubtedly lead to higher energy costs.

Thank you very much.

Mr. ANDERSON. Thank you, Mr. Hunter, for an excellent statement. You may have answered this, but let me ask it again so we can clarify it a little bit. In illustrating your point, Mr. Hunter, that energy costs are a major contributor to the total production costs of many foods, you say that they constitute over 22 percent of the farm price of a bushel of corn.

Yet we received testimony yesterday stating that H.R. 2677 would I believe add at the most a penny to the price of a gallon of oil. How do you reconcile those two facts?

Mr. HUNTER. Agriculture, Mr. Chairman, is a very intensive user of energy. The statistics, and I checked them when I was redoing this paper we presented before other committees in 1981, the latest numbers we have, the energy costs that were used in Iowa to produce corn were 22 percent of the cost of the grain or the money that was received that year for that——I do not have any later statistics than that. If we do, I would be glad to get them and provide them to the committee.

Mr. ALBOSTA. Would the chairman yield?

Mr. ANDERSON. Yes.

Mr. ALBOSTA. I think I might be able to help. I have been a farmer all my life and I think I know where the nitrogen comes from that goes into the corn.

Mr. HUNTER. Yes, sir.

Mr. ALBOSTA. It comes from natural gas. That nitrogen alone can be 20 or 25 percent of the total cost of that bushel of corn. It is pretty obvious when you have that need for that nitrogen that that adds to the cost of that pipeline and equates back to the bushel of corn in a different manner than the energy used to produce, to work the ground, run the tractors or combine.

Mr. HUNTER. Right. It is not just fuel. Thank you very much for your help.

Mr. ANDERSON. That is the energy, 22 percent of the farm price of a bushel of corn. Can you relate that though to the cost of transportation to a bushel of corn for this whole formula you were kind of working out here?

Mr. HUNTER. I don't have any statistics on that with me. What just the transportation component might be? Is that your question?

Mr. ANDERSON. Yes.

Mr. HUNTER. I would be glad to try to get that back to your committee.

Mr. ANDERSON. I wish you would, yes.

Mr. HUNTER. OK.

Mr. ANDERSON. If rates are deregulated as they are in H.R. 2677, would it make any difference to you whether the common carrier obligation and discrimination prohibitions were maintained, or would these become irrelevant?

Mr. HUNTER. I listened to those types of questions yesterday and would like to answer in this way. Farmland, for years, has been involved in a situation basically through the case that we have been involved in. We have been asking for financial access to these pipelines; that is, rates that allow us to be competitive in the markets that we serve, generally the rural marketplace.

Without financial access, physical access is not really important. We tend to focus basically on the rates that would allow us to be competitive, and the financial access. Coming from a common carrier background, I really don't think that question is important to us, nearly as important to farmers and ranchers, as just having the wherewithal financially to ship product on those systems. I guess, you know, I might have the physical access to buy a Rolls Royce. But I don't have the financial access to do that.

Mr. ANDERSON. If rate deregulation was done on a case-by-case basis, would it be more palatable to you?

Mr. HUNTER. I am afraid my viewpoint is fairly narrow-minded on this, Mr. Chairman. I have grown up, lived in the Midwest all my life and seen what is happening with the petroleum products, crude pipelines there. I can't speak for the entire country. I know certain situations in our geographical area of the world are very noncompetitive and I do not think that they need to be deregulated as H.R. 2677 would have them. Other parts of the country face entirely different circumstances.

The shippers have different needs, the pipelines have different owners. And I really don't understand, and I have not seen the study that was referred to yesterday about this two-thirds, one-third deregulation. I am basically just a very narrow-minded person I guess in the midcontinent, and I know what I see there, and I really don't know much about the rest of the pipeline business.

Mr. ANDERSON. I thought you were going to say you were just a country boy.

Mr. HUNTER. No.

Mr. ANDERSON. They are the ones we worry about.

Mr. HUNTER. Yes.

Mr. ANDERSON. Mr. Smith?

Mr. SMITH. Thank you, Mr. Chairman.

Mr. Bale, president of Williams Pipeline Co.——

Mr. HUNTER. Yes; I know him.

Mr. SMITH. I am sure you do—testified in a statement indicating that a pipeline company such as his could be captive to its shippers.

Mr. HUNTER. I have heard him say that.

Mr. SMITH. He used the example, with which you are familiar, and I want you to expand on it, of your Coffeyville, Kans., refinery, indicating that he, Williams, had expanded his capacity several times at your request. And now Williams says he is unlikely to benefit from any investment because you are now committed to a new MAPCO pipeline for part of your supply.

Would you comment on that?

Mr. HUNTER. Yes, sir, Mr. Smith. Farmland is a major shipper on the Williams system. Much of the revenue generated comes from Farmland. We distribute petroleum products throughout Nebraska, Kansas, Iowa, many States. Their revenues keep increasing each year even though their units of transportation are going down. I don't know the history of all of his expansion projects. I know we are a major shipper, we intend to continue to be a major shipper on Williams because they have the only way to get to the places we go.

So we have to use them and, yes, he is dependent upon us for revenue so that is a true statement. Expansions, I don't have all of the knowledge of. I worked for Farmland about 9 years, not as long as the rate proceeding with FERC and previously ICC has been going on. So I can't really speak to all that.

The Mapco system was part of your question. Williams and Mapco were bidders on that. There were two reasons to build that. No. 1 was to bring feedstocks into the refinery because trucks were just exorbitant. No. 2, to take a few petroleum products away from the refinery, connect with Kaneb system so we could serve with other parts of the Midwest, because we shut down our Phillipsburg refinery 15 months. Williams had a chance to bid on that. They bid higher than the other company. We took the lower bid.

Mr. Smith. I don't want to get involved in the struggle, but I did want an opportunity for you to answer that.

Mr. Hunter. I like that philosophy that we are captive to them and they are captive to us. It reads well.

Mr. Smith. Kind of interesting, isn't it? Are you testifying that current regulation is adequate for you?

Mr. Crites. No, we are not. We tend to agree that the regulation today has been as charaterized by Professor Mitchell and also Congressman Bedell, I think we tend to agree with him that we ought to be looking at what regulation should be in the face of the fact that we have not experienced over our twelve years of litigation effective regulation to date.

Mr. Smith. So it is not, regulation today is not to your satisfaction. Yet you are saying we ought to retain it?

Mr. Crites. No, we are saying we should not deregulate the authority that is provided. We do not believe FERC has effectively exercised their authority to regulate the pipeline.

Mr. Smith. Thank you, Mr. Chairman.

Mr. Anderson. Mr. Daub?

Mr. Daub. Good morning, Mr. Chairman. Thank you, Mr. Chairman.

You were good competitors with the company that I worked for.

Mr. Hunter. Which one was that?

Mr. Daub. Standard Chemical Manufacturing Co. in Omaha, Nebr. Manufactured livestock feeds for cattle and hog producers. Got acquainted with you and know a little bit about the way in which your operations function.

What would we do with the present regulatory process to avoid 12 years plus of Williams being tangled up in the process?

How do we streamline or change it, either one of you?

Mr. Crites. The approach we believe is approriate is the just and reasonable rate approach which has been utilized in a number of areas of regulation and we believe that is appropriate for the pipelines. We do not believe FERC has ever implemented that. We think they have the authority to implement it and that they should.

Mr. DAUB. And the current interpretation and/or enforcement doesn't accomplish just and reasonable——

Mr. CRITES. We don't believe it does.

Mr. HUNTER. We have been arguing contrary for about 11 years.

Mr. DAUB. If, then, contrary to your request, Congress were to grant the deregulation sought by the industry, what would your position be with respect to the retention of common carrier regulation and prohibition against price and service discrimination?

Mr. HUNTER. As we previously mentioned just a little bit ago, Mr. Daub, we are very interested in what I call financial access to these pipelines. Without financial access, tariffs that allow us to be competitive in Iowa, Nebraska, then physical access doesn't really accomplish much, that is, common carrier access.

We are very concerned about the tariffs and ratemaking and control over that. Until yesterday I had not given the common carrier status much thought. I think that those companies will tend to be common carriers, whatever happens, and that doesn't concern me nearly as much as financial access.

Mr. CRITES. If I may add to that, the provisions, as I understand them in the bill with respect to discrimination are totally inadequate in the way that they are set up in the first place.

The most that could happen, and with our experience and what happened after 12 years, the Commission could say stop that, with no affirmative action as to what they should do. So then the company is free to go back and do something else.

Then we start all over on the process. So the way it is presently set up, regardless of how beneficial you might think common carriers would be, it doesn't provide the remedy that is necessary. We think it is an artificial remedy and the real problem is the access at a reasonable price. If the price is unreasonable, theoretical access is of no benefit.

Mr. DAUB. And no regulation is going to change that one way or the other, is it?

Mr. CRITES. We think that reasonable regulation would provide reasonable rates, in which event we don't have to worry about the access problem.

Mr. DAUB. Thank you, Mr. Chairman.

Mr. ANDERSON. Following up on that, do you feel rates are influenced by the fact that the line is probably owned by a company that also uses it, and keeps the rates that doesn't affect them because they just carry it as part of their costs? Do you think that is part of your problem, or is it something else?

Mr. CRITES. That may be the problem, and I think it probably is in some pipelines where you have the owners shipping over the pipeline, and then, of course, they get the benefits of any high rates that they are charged on that pipeline.

In our case, we have a little different problem in that some of the pipelines we ship over are not owned by major oil companies.

Mr. ANDERSON. But the costs are still too high.

Mr. CRITES. Right.

Mr. ANDERSON. Higher than you think reasonable?

Mr. CRITES. Right.

Mr. ANDERSON. Have you had any way of determining that, that the costs are unreasonably higher or is it just your idea that they are too high?

Mr. CRITES. We have done some studies, and I am not prepared to give those numbers today. I could supply those.

We have done that in the testimony that we have presented throughout the litigation. What we think would be reasonable rate methodologies. Part of our problem too is, I think we have never gotten to the point in litigation where we have had all the information necessary to try to apply reasonable rates to a reasonable rate base, so I think we still have some questions we have never really been able to answer to come up with specific numbers.

Mr. ANDERSON. Does the name Rich Kowalewski mean anything to you?

Mr. HUNTER. Rich Kowalewski?

Mr. CRITES. It does to me, Mr. Chairman.

Mr. ANDERSON. It does? He was first string staff here on the committee. It is kind of an aside. Here I go to work. We hire nice young people, we train them, we get them to where they are really valuable to us; we need them. Then you people steal them from us. He is working with you now.

Mr. CRITES. With our company, yes.

Mr. ANDERSON. If he was still working with me, he would be sitting where Paul Schlesinger is. I guess Paul's glad that you stole him away.

If you see Rich, tell him we miss him.

Mr. CRITES. I certainly will.

Mr. ANDERSON. Not too much.

Mr. HUNTER. Thank you, Mr. Chairman. This is my first time to participate. I appreciate your interest and enjoy it very much.

Mr. ANDERSON. Our next witness is Mr. R. Thomas Van Arsdall, vice president, agricultural inputs and services, National Council of Farmer Cooperatives.

Mr. Van Arsdall, the full text of your prepared statement will appear in the record at this point.

[Statement referred to follows:]

STATEMENT OF R. THOMAS VAN ARSDALL, VICE PRESIDENT, AGRICULTURAL INPUTS AND SERVICES, NATIONAL COUNCIL OF FARMER COOPERATIVES

Mr. Chairman and Members of the Subcommittee, my name is R. Thomas Van Arsdall, and I am vice president of agricultural inputs and services with the National Council of Farmer Cooperatives. The National Council is pleased to have the opportunity to appear and testify before this Subcommittee on the issue of regulatory reform of the oil pipeline industry, in particular as proposed in H.R. 2677, the "Oil Pipeline Regulatory Reform Act of 1983."

The National Council of Farmer Cooperatives is a nationwide association of cooperative businesses which are owned and controlled by farmers. Its membership includes 109 marketing and farm supply cooperatives, the 37 banks of the cooperative Farm Credit System, and 32 state councils of farmer cooperatives. National Council members handle practically every type of agricultural commodity produced in the United States, market these commodities domestically and around the world, and furnish production supplies and credit to their farmer members and patrons. Two-thirds of United States farmers are affiliated with one or more cooperatives. The National Council represents about 90 percent of the more than 6,400 farmer cooperatives in the nation, with a combined membership of nearly 2 million farmers.

Among the farmer cooperatives the National Council represents are supply cooperatives which own and operate five efficient refineries possessing an aggregate production capacity of 301,000 barrels per day, and whose yields of gasoline, diesel fuel and heating oil amount to approximately 85 to 90 percent of their refined products. While this represents less than two percent of United States refining capacity, cooperatives market petroleum products in more than 40 states and currently supply about 45 percent of all on-farm fuel and a large portion of rural needs.

The National Council has examined the provisions of H.R. 2677, and must register strong opposition. Contrary to the goal of "regulatory reform" implies in its title, this bill in reality would achieve de facto deregulation of economic ratemaking practices in an industry which clearly exhibits monopoly characteristics. Resultant market distortions and monopoly rents would accrue to the benefit of pipeline interests at the expense of agriculture and rural America.

We are opposing oil pipeline rate deregulation, even though some of our members either own oil pipeline outright or engage in joint ownership in order to overcome problems they have encountered as captive shippers. These same cooperatives also are highly dependent on pipelines in which they have no ownership.

The NERA study on competition in oil pipeline markets found strong evidence of monopolistic conditions, with major barriers to entry.[1] Their analytical approach focused on point-to-point competition. We believe that this is the most appropriate measure, and endorse the findings of the NERA study.[1] Similar conclusions were reached by James Love of Princeton University in a subsequent analysis of oil pipeline regulation.[2]

Cooperatives and rural areas are generally highly dependent on a single pipeline company, either for the movement of crude oil to the refinery serving that market or for the delivery of petroleum products. Most rural areas do not have alternate forms of transportation that could compete economically with an oil pipeline—especially when they are land-locked and remote from high density markets. Sharp and unreasonable increases in pipeline tariffs due to deregulation would increase farmers' costs of production, as well as adversely impact upon the entire agricultural and rural economy. These impacts are not "sub-microscopic" as asserted by the FERC. More than a dozen regional cooperatives and thousands of locals are involved in supplying petroleum products to farmers. These farmers are not just customers—they are the owners of the system. Monopoly rent transfers to oil pipeline interests are taken from these farmers' pockets. Therefore, we believe the market power possessed by most oil pipelines constitutes a sufficient danger to justify the retention of Federal rate regulation.

Future competition is also unlikely from other pipelines, as market demand probably will remain fairly constant in most rural areas, with a relatively fixed demand for product at a specific destination. The first pipeline in the market, if that pipeline meets most of the minimum market requirements, will enjoy a cost advantage over potential competitors in that same market. Therefore, competition is unlikely to materialize because of the inherently disadvantageous position of new pipelines. The complex and burdensome environmental and eminent domain issues inherent in the construction permitting process also serve as major obstacles. Because of the characteristics of the market, the first pipeline becomes a monopolist in that market if properly sized. As a result, many petroleum pipelines have the opportunity and the power to extract excessive tariffs from any of their customers and shippers in the absence of effective economic rate regulation.

Pipeline ownership is dominated by vertically integrated major oil companies, which use pipelines principally to transport their own products. Under current Federal rate regulation, shipper-owners are at a distinct competitive advantage because the portion of the tariff beyond actual transportation costs is returned to them in the form of dividends. Imposition of excessively high tariffs would expand such earnings, sharply increasing the distinct competitive advantager shipper-owners already possess.

Conversely, while we believe deregulation is not the answer, neither is the status quo. It is our belief that Federal regulation of the oil pipeline industry has not been that effective over the years. A GAO study released in July 1979 supported this view and recommended that the Federal Energy Regulatory Commission implement rate reform. It also urged that "criteria should be established for determining the justness and reasonableness of oil pipeline rates and sufficient regulation procedures implemented to assure that the criteria are followed." [3]

---

[1] "Competition in Oil Pipeline Markets: A Structural Analysis." Robert E. Anderson and Richard T. Rapp, National Economic Research Associates, Inc. April 20, 1983.

[2] "Oil Pipeline Regulation." James Packard Love, Princeton University and the Center for Study of Responsive Law. September 26, 1983.

[3] "Petroleum Pipeline Rates and Competition—Issues Long Neglected by Federal Regulators and in Need of Attention" (U.S. General Accounting Office, 1979).

Existing law provides adequate authority and direction to the FERC. We deplore the fact that the FERC has not taken these important steps and would hope that they will proceed to do so expeditiously. We feel action is necessary to assure that the interests of shippers, as well as the public at large, are adequately represented in arriving at fair and reasonable pipeline rates.

Despite the fact that Federal regulatory involvement in rate-making has been limited, we are of the strong opinion that an administrative forum must continue to exist to afford the opportunity for shippers to challenge economically unwarranted increases in pipeline tariffs. Such a regulatory forum is essential, given the market power possessed by most oil pipelines. Competitive conditions are the exception rather than the rule.

In conclusion, Mr. Chairman, we believe petroleum pipelines generally possess the characteristics of natural monopolies. The very nature of this system dictates that, with a few exceptions, true competition as a disciplinary force in the marketplace is not practicable. It is a long-established principle that where such conditions prevail, it is an appropriate and necessary role of Federal Government to assure equitable treatment of the user community while maintaining a fair rate of return for investors. Members of the National Council are carefully reviewing the existing regulatory structure in a search for alternatives which would more effectively accomplish these objectives.

Mr. Chairman, we appreciate the opportunity to testify today, and would be pleased to respond to any questions that you or other Members of the Subcommittee might have.

Mr. ANDERSON. Please proceed.

TESTIMONY OF R. THOMAS VAN ARSDALL, VICE PRESIDENT, AGRICULTURE INPUTS AND SERVICES, NATIONAL COUNCIL OF FARMER COOPERATIVES

Mr. VAN ARSDALL. Thank you, Mr. Chairman.

By the way, I was speaking with Rich Kowalewski yesterday. He serves on the National Council's Transportation Policy Committee.

Mr. ANDERSON. I know he is doing pretty good. I take some credit for that.

Mr. VAN ARSDALL. He keeps us hustling. The National Council has examined the provisions of H.R. 2677 and must express strong opposition. Contrary to the goal of regulatory reform implied in the title, we believe this bill in reality would achieve de facto deregulation of economic ratemaking practices in an industry which clearly exhibits monopoly characteristics.

We are opposing oil pipeline rate deregulation, even though some of our members either own oil pipelines outright or engage in joint ownership in order to overcome problems they have encountered as captive shippers.

These same cooperatives also are highly dependent on pipelines in which they have no ownership.

The NERA study on competition in oil pipeline markets found strong evidence of monopolistic conditions with major barriers to entry. Their analytical approach focused on point to point competition. We believe that this is the most appropriate measure, and endorse the findings of the NERA study. Similar conclusions were reached by James Love of Princeton University in a subsequent analysis of oil pipeline regulation.

Cooperatives and rural areas are generally highly dependent on a single pipeline company, either for the movement of crude oil to the refinery serving that market or for the delivery of petroleum products. Most rural areas do not have alternate forms of transportation that could compete economically with an oil pipeline—especially when they are landlocked and remote from high-density markets.

Sharp and unreasonable increases in pipeline tariffs due to deregulation would increase farmers' costs of production, as well as adversely impact upon the entire agricultural and rural economy.

These impacts, as the previous witness said, are not sub-microscopic as asserted by the FERC.

I might shed some additional light on the dollar aspects resulting from a 1 cent a gallon increase. The example of energy costs in corn representing 22 percent of production cost was substantially correct. A good deal of anhydrous ammonia is shipped by pipeline also. The proposed legislation, H.R. 2677, could easily be interpreted as deregulating the ratemaking practices of anhydrous ammonia pipelines. So you could have a full impact on corn presumably. You are looking at about 8 billion gallons annually in gasoline and diesel fuel used on the farm. A 1 cent per gallon increase in transportation rates, if translated into a cost increase for all farmers costs of production, could translate into about $80 million annually from that 1 cent increase. If you compare that to net farm income, it doesn't seem like a lot when you break it down to percentages. It is about one-half of 1 percent impact on net farm income, because the farmer cannot pass those increases along in the marketplace in which he operates. That is a competitive marketplace. If all increases across the entire food system were passed on to the customer, a 1-cent-per-gallon increase would generate about a 0.1- to 0.2-percent increase in consumers' food costs.

That doesn't again seem like much, but it adds up pretty quickly when you look at a number of other factors that seem to interact to increased farmers' costs or food system costs.

You can break anything down to small enough numbers to make it seem "de minimis," and use that as justification for a regulatory action. I have had occasion to try to do that myself.

More than a dozen regional cooperatives and thousands of locals are involved in supplying petroleum products to farmers. These farmers are not just customers—they are owners of the system. Monopoly rent transfers to oil pipeline interests are taken from these farmers' pockets. Therefore, we believe the market power possessed by most oil pipelines constitutes a sufficient danger to justify the retention of Federal rate regulation.

Conversely, while we believe deregulation is not the answer, neither is the status quo. It is our belief that federal regulation of the oil pipeline industry has not been that effective over the years.

A GAO study released in July 1979 supported this view and recommended that the Federal Energy Regulatory Commission implement rate reform. It also urged that—

> Criteria should be established for determining the justness and reasonableness of oil pipeline rates and sufficient regulatory procedures implemented to assure that the criteria are followed.

Existing law provides adequate authority and direction to the FERC. We deplore the act that the FERC has not taken these important steps and would hope that they will proceed to do so expeditiously, although our hopes at this time aren't necessarily that high.

We feel action is necessary to assure that the interests of shippers, as well as the public at large, are adequately represented in arriving at fair and reasonable pipeline rates. An effective administrative forum must continue to exist to afford the opportunity for shippers to challenge economically unwarranted increases in pipeline tariffs. Given the market power possessed by most oil pipelines, this regulatory forum is essential. Competitive conditions are the exception rather than the rule.

In conclusion, Mr. Chairman, we believe petroleum pipelines generally possess the characteristics of natural monopolies. The very nature of this system dictates that, with a few exceptions, true competition as a disciplinary force in the marketplace is not practicable.

It is a long-established principle that where such conditions prevail, it is an appropriate and necessary role of Federal Government to assure equitable treatment of the user community while maintaining a fair rate of return for investors.

We are carefully reviewing the existing regulatory structure in a search for alternatives which might more effectively accomplish these objectives. We were hopeful that the FERC would be forthcoming with those so we could react to them. Unfortunately, it appears that we may have to take the initiative in our own hands.

Mr. Chairman, we appreciate the opportunity to testify today and would be pleased to respond to any questions that you or other members of the subcommittee might have.

Mr. ANDERSON. You added a term there, anhydrous ammonia. Do you ship that in pipelines?

Mr. VAN ARSDALL. A good deal is nationally. I believe even by some of our members who are in the fertilizer manufacturing business.

Mr. ANDERSON. Is that an oil product?

Mr. VAN ARSDALL. No, it is from natural gas.

Mr. ANDERSON. How would it be subject to an oil pipeline regulation? It is not a petroleum product.

Mr. VAN ARSDALL. That is correct.

Mr. ANDERSON. Would it be under the regulation?

Mr. VAN ARSDALL. It would not go through petroleum pipelines, but many interpretations of the various proposals that have been offered over the last couple of years to deregulate rate-making practices for pipelines could easily be interpreted to apply to anhydrous ammonia pipelines also.

A lot of people are wishfully thinking that it will not, especially those in the anhydrous ammonia industry.

Mr. ANDERSON. I am thinking on the oil pipeline regulation, I am thinking of a petroleum product.

Mr. VAN ARSDALL. Exactly.

Mr. ANDERSON. Not something other like this, also a subject you would use.

Mr. VAN ARSDALL. Some of our outside counsel and member counsel have told us to beware, that the proposed legislation very easily could be interpreted to deregulate anhydrous ammonia pipelines.

Mr. ANDERSON. Mr. Van Arsdall, your membership seems extensive. Does your statement reflect their views, or are there some who would dissent, and on what grounds?

Mr. VAN ARSDALL. My statement does reflect their views in the energy and transportation areas, the National Council policy process operates on a consensus. If there is a divided opinion, we do not move forward on an issue. We let the members work them individually. This is a consensus position of our members.

Mr. ANDERSON. So any position you state here would be not just a 51 percent, but a rather overwhelming majority?

Mr. VAN ARSDALL. It is a consensus which means complete agreement on our Energy Committee.

Mr. ANDERSON. That is hard to do.

Mr. VAN ARSDALL. It is tough to do, and often requires extensive deliberation.

Mr. ANDERSON. You say the pipeline industry clearly exhibits monopoly characteristics. Yet just yesterday Prof. Edward Mitchell told us that in the 59 largest metropolitan areas those served by at least 1 product pipeline is served by an average of 1.6 local refineries and three product pipelines for a total of 4.5 independent entities.

He said because transportation costs of barge and tanker was comparable to that of pipelines, these provide competition.

Would you see any problem with deregulating these, those pipelines that face competition?

Mr. VAN ARSDALL. East coast pipelines?

Mr. ANDERSON. Those that face competition.

Mr. VAN ARSDALL. I have looked at Dr. Mitchell's study, as well as the NERA study and the one produced recently by Mr. Love.

My background is economics. There are all sorts of different ways you can maneuver statistics. I would suggest Dr. Mitchell's study vastly overstates the conclusion that there are competitive conditions existing in every metropolitan area. If you look at point-to-point competition and if you look into the ownership characteristics, I think you will find a large number of exceptions to the contrary.

I would suggest that indeed there are undoubtedly some pipelines, point-to-point competition or some market areas that have plenty of competition, but I would suggest that if there is going to be any deregulation that clearcut criteria be established first which take into account an adequate measure of competition.

I have not seen such a measure defined as yet. Pipeline deregulation should be evaluated on a case-by-case basis, with opportunity for public input. The burden of proof should be on the pipeline rather than on the user community.

Mr. ANDERSON. Now, yesterday the administration witnesses, the ones we heard from yesterday, all supported deregulation. Have you and your members provided the administration with input, letting them know of your opposition to the proposals.

Mr. VAN ARSDALL. They are aware of our opposition. They have never invited our input, and we have not been successful in accomplishing direct discussions or negotiations with them on this issue.

Presently we seem to be polarized in our views on this issue. We have supported deregulation of many industries. We just find that in terms of national policy the petroleum pipeline industry should not be deregulated.

Mr. ANDERSON. Mr. Smith?

Mr. SMITH. Thank you, Mr. Chairman.

Following the chairman's line of questioning, do you have any—you mentioned the monopolistic positions of some pipelines. Do you have any specific examples of that that you would care to present?

In your area, for instance, is the pipeline a monopoly and, if so, why?

Mr. VAN ARSDALL. When you say "my area" I guess we are covering more than 40 States around the country.

Mr. SMITH. In 40 States?

Mr. VAN ARSDALL. I would have to provide specific examples, but, interestingly enough, I really expected divided opinion among our members. We have members that serve the Northeast market, for example.

Mr. SMITH. Would you mind doing that for me?

Mr. VAN ARSDALL. I will ask my members to do so.

[See letter from Mr. Van Arsdall, below.]

Mr. SMITH. I am sure there are other areas that pipelines are competitive.

Mr. VAN ARSDALL. I thought that members in the Northeast area would say that pipeline deregulation presents no problem. Interestingly enough, AGWAY, which serves the Northeast, expressed a number of concerns with rate deregulation even though that region is served by Colonial and Plantation, for example, and tanker traffic.

Mr. ANDERSON. Mr. Daub.

Mr. DAUB. Thank you.

Break down the membership in terms of percentage of either outright pipeline ownership or joint venture ownership. Would you do that, please?

Mr. VAN ARSDALL. OK.

[The following was received from Mr. Van Arsdall:]

NATIONAL COUNCIL OF FARMER COOPERATIVES,
Washington, D.C., November 21, 1983.

Hon. GLENN M. ANDERSON,
Chairman, Surface Transportation Subcommittee of the House Public Works and Transportation Committee, Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: During my November 10 testimony on the issue of petroleum pipeline deregulation, I was asked to provide additional information for the record by Congressman Robert F. Smith (examples of monopolistic positions of pipelines) and by Congressman Hal Daub (cooperative pipeline ownership, and challenges of pipeline tariff increases over the past five years).

We intend to survey our petroleum cooperatives in the near future regarding this information. Unfortunately, we do not anticipate that composite results will be available until early next year. We are taking the liberty of enclosing a study by the USDA Agricultural Cooperative Service which provides some statistics on pipeline ownership in 1979. The ACS is presently conducting a survey in order to update this report to 1982.

According to the ACS survey, pipelines owned by cooperatives in 1979 totaled 928 miles, up from 258 miles in 1950. Seventeen percent of refinery output was transported in cooperative pipelines. Cooperatives also owned 1,176 miles of gathering and 176 miles of trunk pipelines to move 32 million barrels of crude oil in 1979. Only 23 percent of crude oil processed for their own use was moved by cooperatives in their own pipelines. The treatment of joint or partial ownership in pipelines is unclear. Cooperatives do have ownership in several pipelines.

We regret that complete responses will not be available for inclusion in the November 10 hearing transcript. The information will be made available to the Subcommittee once compiled.

Respectfully,

R. THOMAS VAN ARSDALL,
Vice President, Agricultural Inputs and Services.

Mr. DAUB. How many of your members who ship on oil pipelines have actually challenged so-called economically unwarranted increases in pipeline increases over the last 5 years?

Mr. VAN ARSDALL. Just a sort of editorial comment on that.

Mr. DAUB. Yes, fine.

Mr. VAN ARSDALL. I recall justification by several parties that rate increases must not be a problem, because not that many challenges have been instituted. But I think a number of people have looked at what has occurred in the Williams Brothers case, applied that circumstance to their own particular situation, and have said, "what is the use in the current environment?"

Mr. DAUB. I appreciate that. That is really all that I have, Mr. Chairman.

Mr. ANDERSON. Thank you, Mr. Daub.

Thank you, Mr. Van Arsdall, for an excellent presentation.

Mr. VAN ARSDALL. Thank you.

Mr. ANDERSON. Our next witness is Mr. James Love, Center for Study of Responsive Law.

Mr. Love, your prepared statement will be made a matter of the record at this point.

[Statement referred to follows:]

STATEMENT OF JAMES LOVE

Thank you for the opportunity to submit comments on legislative proposals to deregulate some oil pipelines. I am providing the Committee with a September 26, 1983 study entitled "Oil Pipeline Regulation" that I recently completed for the Center for Study of Responsive Law, and ask that it be included in the record of this hearing. The Center study is an economic analysis of oil pipeline regulation, with a particular emphasis on issues that are central to the current deregulation debate. It is one of three studies I have undertaken for the Center on recent developments in economic regulation by the federal government; the other two involve proposals to deregulate cable television and "captive shippers" on railroads.

The purpose of the three studies is to examine the case for deregulation in industries where the traditional arguments for public utility style regulation are strong, and where political pressure for deregulation comes from shippers, rather than consumers. In particular, I am looking at industries where economies of scale and the existence of large sunk costs suggest a market structure with monopoly power. This is in contrast to the trucking and airlines industries, where economies of scale are small relative to many markets and capital investments are mobile.

The oil pipeline industry's technological features suggest that it is a natural monopoly. First, economies of scale exist, as the capacity of a pipeline increases roughly with the square of the radius of the pipe, while the construction and operating costs increase much more slowly. Second, much, if not most, of the cost of building a pipeline is "sunk" in investments that have little or no salvage value should the pipeline be taken out of service. It is the combination of these two factors that suggest oil pipelines are monopolies. That is, not only is it more efficient for one pipeline to serve a given "point to point" market, but the fact that the incumbent firm cannot exit the market without abandoning its investment serves to deter new entry into the market by potential rivals.

The proponents of deregulation say oil pipelines do not have monopoly power, and competition will protect shippers and consumers from monopoly pricing or discriminatory access to pipeline facilities. A number of arguments are used to support this position, the most important of which are:

1. Pipelines face competition from trucks, barges, and tankers;
2. Unlike other regulated industries, there is no legal barrier to market entry;

3. Because pipelines are durable, and markets change over time, many markets are in fact served by more than one pipeline;

4. Where pipelines are owned and operated as undivided interest pipelines, the different owners of a pipeline compete against each other, and;

5. Even where pipelines do appear to have monopoly power, this is offset by the monopsony power of the shippers.

These arguments were not found to be a sufficient justification for oil pipeline deregulation, based on the following:

1. Although pipelines do face intermodal competition, in most cases the alternatives are substantially more expensive and just set an upper bound on the monopoly prices that can be charged.

2. The fact that the government does not require a certificate of convenience and necessity to operate an oil pipeline does not mean that there are no barriers to market entry. Environmental permits often present substantial entry barriers. More important, the fact that most pipeline costs are "sunk" deters potential entrants from entering a market where the incumbent firm already has invested in enough capacity to serve the market.

3. While some markets are indeed served by more than one pipeline, there is a high degree of cross ownership between different pipelines, thus reducing competition.

4. Undivided interest ownership agreements frequently include clauses that allow throughput capacity to be limited, providing the pipeline owners a handy mechanism for enforcing cartel levels of output. The available evidence suggests that the owners of undivided interest oil pipelines do not operate as competitors.

5. If all present and future shippers were known and acted together in bargaining with the pipeline owners, rates would be equal to pipeline costs. In a world with uncertainty about where oil is and how markets will develop over time, however, there is also uncertainty about who the future shippers will be. Present and future shippers cannot bargain together, and thus monopsony power is weakened. Moreover, most oil pipelines are owned by the dominant shippers, leaving smaller shippers with little bargaining clout.

The case of oil pipeline deregulation just doesn't hold up under close examination. The paper lists three reasons to be concerned about pipeline monopoly power.

First, pipeline owners have the power to exploit upstream producers. Aside from the distributional and equity issues raised, this will lead to economic waste, as producers will make production decisions based on tariffs that exceed costs.

Second, in some markets pipelines will have the power to raise prices to consumers. The pipeline companies have argued that price increases will be small on a percentage basis, but in absolute terms price increases are likely to represent a transfer of tens or hundreds of millions of dollars from consumers to pipeline owners.

Third, because crude oil production taxes and royalties paid to federal and state governments are based on wellhead values, high pipeline tariffs will lead to lower public revenues. The federal government will lose billions of dollars in windfall profits taxes and lease receipts if oil pipeline tariffs are not effectively regulated.

While there is an important public interest in regulating oil pipelines, in practice there has never been an adequate federal regulatory system. In the late seventies shipper groups, the State of Alaska, the Justice Department, and the Senate Judiciary Committee, under the Chair of Senator Kennedy, all began pushing for reforms of oil pipeline regulation. The first target was the antiquated regulatory method used by the I.C.C. to set pipeline rates. The Justice Department and Senator Kennedy also took a hard look at oil pipeline divestiture.

Among regulatory experts, I.C.C. rate-making practices were a bad joke. Rate base, depreciation, and allowable rates of return were based on a bizarre set of calculations that were without any apparent rationale. After a good deal of criticism, including a stinging rebuke from the U.S. District Court of Appeals in the 1978 *Farmers Union* case, the I.C.C., and later its successor in pipeline regulation the FERC, began to adopt modern rate-making practices for the oil pipeline industry. The high water mark in rate reform came in a 1980 FERC hearing officers' initial decision in the TAPS case, where an orthodox public utility rate-making methodology was adopted.

The proposal to require vertical divestiture of oil pipelines spawned several important empirical investigations into the structure of oil pipeline markets. One of the most interesting was a 1980 draft DOE study prepared by Leonard Coburn. Although the report's findings were described as tentative, and it did not make clear policy recommendations on the divestiture question, it provided ample evidence of monopoly power in pipeline markets. Of particular interest to this Committee is the Appendix VIII, titled "Evidence Memorandum," which is an eye-opening account of abuses by major oil companies against non-owner shippers on oil pipelines. I am providing the Committee with a copy, and ask that it be included in the record of this hearing.

These efforts to check the monopoly power of oil pipelines were dramatically reversed when President Reagan was elected. The investigation into the divestiture question stopped. This was followed by the FERC's stunning decision in the *Williams Brothers* case. In apparent disregard to the entire record of its generic rulemaking proceeding, the FERC, largely relying on a rambling historical review of the Standard Oil Trust and the legislative history of the 1906 Hepburn Act, declared that pipeline regulation was no longer necessary. The FERC said the consumer interest in oil pipeline regulation was "sub-microscopic," and the oil pipeline problem was "something on the order of an ingrown toenail." Thus, the FERC announced it would use its regulatory powers only "in cases of egregious exploitation and gross abuse." It adopted the old I.C.C. method of determining the pipeline rate base and depreciation, despite its admission that in the case of the rate-base methodology, "rigorous logic and Euclidean consistency are not the system's most striking features," and the depreciation schedules were based on "ancient studies." When it turned to the question of the allowable rate of return, the FERC created a novel multiple choice system that one dissenting commissioner called "the regulatory equivalent of dialing for dollars."

If the *Williams Brothers* decision is allowed to stand, the FERC will have accomplished de facto deregulation, or at least, moved far in that direction, through administration action.

If the Committee wants to protect competition in crude oil production, and the interests of consumers and taxpayers, it will not only reject the legislative proposals to deregulate oil pipelines; it will seek to reverse the Reagan Administration's efforts to deregulate oil pipelines administratively.

Mr. ANDERSON. Please proceed.

TESTIMONY OF JAMES LOVE, CENTER FOR THE STUDY OF RESPONSIVE LAW

Mr. LOVE. Thank you.

First, I am not Dr. Love, as mentioned by the previous witness. I am Mr. Love. I would just like to set the record straight on that.

Mr. ANDERSON. Thank you.

Mr. LOVE. I would like to thank you for the opportunity to submit comments on legislative proposals to deregulate oil pipelines. I am providing the committee with a September 26, 1983, study entitled Oil Pipeline Regulation that I recently completed for the Center for Study of Responsive Law.

[The study referred to was retained in the subcommittee files.]

The center study is an economic analysis of oil pipeline regulation, with a particular emphasis on issues that are central to the current deregulation debate. It is one of three studies I have undertaken for the center where some of the traditional arguments for rate regulation are strong. The other industries are cable television at the local transmission level and captive shippers on railroads, particularly coal shippers.

The oil pipeline industry's technological features suggest that it is a natural monopoly. There has been a lot of testimony on that. There are substantial economies of scale. A point that hasn't been emphasized as much is that there are large sunk costs in building a pipeline and after the pipeline is built it has little or no salvage value if taken out of service in a particular market.

It is the combination of economies of scale and fact that there are sunk costs which suggest there is going to be a monopoly market structure in the oil pipeline industry. This is because a potential entrant knows that if it enters a particular market to compete against an existing pipeline the incumbent firm can't leave without abandoning its investment. That is an important difference between the pipeline industry and some other industries. In particular, it is important to distinguish between what you see in the oil pipeline industry and what you see in the trucking and airline industry where economies of scale are small relative to a lot of markets served by those industries; and also the capital invested in airlines and truck industries can be moved from one place to another if market conditions change.

Proponents of deregulation say oil pipelines do not have monopoly power, and competition will protect shippers and consumers from monopoly pricing or discriminatory access to pipeline facilities. A number of arguments are used to support this position, the most important of which are:

One. Pipelines face competition from trucks, barges, and tankers;

Two. Unlike other regulated industries, there is no legal barrier to market entry, a point emphasized yesterday;

Three. Because pipelines are durable, and markets change over time, many markets are in fact served by more than one pipeline in point to point markets;

Four. Where pipelines are owned and operated as undivided interest pipelines, the different owners of a pipeline compete against each other—this is a point I think Dr. Barber will address later today; and

Five. The argument has been made that even where pipelines do appear to have monopoly power, this is offset by the monopsony power of the shippers. I think the argument earlier today was that the pipeline is the captive.

I examined these arguments point by point. I think the response is first, that in the case of intermodal competition, in most cases the alternatives are substantially more expensive and just set an upper bound on the monopoly prices that can be charged.

Second, the fact that the Government does not require a certificate of convenience and necessity to operate an oil pipeline does not mean that there are no barriers to market entry. Environmental permits often present substantial entry barriers. More important, the fact that most pipeline costs are sunk deters potential entrants from entering a market where the incumbent firm already has invested in enough capacity to serve the market.

While some markets are indeed served by more than one pipeline, there is a high degree of cross ownership between different pipelines, thus reducing competition. The 18 largest pipelines belong to about 10 such partnerships. You have situations where there is common ownership between pipelines serving the same market, if not in that market, in some secondary market.

Fourth, undivided interest ownership agreements frequently include clauses that allow throughput capacity to be limited, providing the pipeline owners a handy mechanism for enforcing cartel levels of output. I think the evidence is that the undivided interest pipelines do not operate as competitors. I can provide more on that if the committee wants.

Five, the question of monopsony power, would be an important argument against regulation if everybody knew who the future shippers were and you did not have the vertical integration that you have right now. But, you have a period where nobody knows where oil is going to be found in the future or how markets are going to develop. The present shippers don't know who the future shippers are. They can't get together and bargain. That creates a real breakdown in the idea of shipper monopsony power. Second, where you have vertical integration and the pipelines are owned by dominant shippers, the small shippers have very little bargaining clout because they don't tender enough oil to finance any size of a pipeline that would be economic. So, when you don't have a coalition with equal interests, the monopsony power breaks down.

I don't think the argument for pipeline deregulation holds up when you look at different markets. There has been a lot of testimony yesterday from the administration that they think there are substantial pockets of monopoly through the industry. How people stand on deregulation just depends on how big they think those pockets are.

The only bindings that there is no monopoly power are the papers and research sponsored specifically by the pipeline industry. If you look at the work by Mr. Hanson, or the 1980 DOE report on the pipeline undersizing problem by Mr. Coburn, and if you look at the NERA shipper sponsored study I think you find substantial empirical support for the fact that there are plenty of instances where there is monopoly power. Certainly there may be some areas where competition reigns. There is no denying that, but the bill, because it deregulates all oil pipelines, would create a number of problems.

There are three reasons why pipeline regulation is important. I think a lot of this has been covered already. Monopoly prices would create distortions in upstream markets that cause economic waste, monopolization of those markets, and reduce the taxes and receipts the Federal Government gets from oil resources. Deregulation will in some cases increase costs to consumers. While this may be small in percentage terms, it is likely to be large in absolute terms.

I think the committee should review the Williams decision.

The committee members are probably aware that the Williams decision is essentially providing for de facto administrative deregulation of pipelines, and the FERC has suggested it may be applied in the TAPS case. I think it is a matter that concerns the committee.

Mr. Anderson. I am going to have to break into your statement because we have to go vote. You are the lucky guy today. You got caught right on the wheel as it went around. The Chairman has called an emergency meeting of the full Public Works Committee. Fifteen minutes after this vote.

Mr. Daub. Yes.

Mr. Anderson. This vote will take about 15 minutes, so we are talking about a meeting he is calling immediately here. So we wouldn't be able to come back here.

The meeting, I am told, will last at least 30 to 45 minutes, so we are going to recess right now until 1 o'clock so we can all go to lunch. We will pick you up at that time. I am sorry we had to cut you in half.

Mr. Love. I was about through.

Mr. **Anderson**. Yes. We have questions for you though. We would like to have you come back if you can.

Mr. **Love**. Sure.

Mr. **Anderson**. One o'clock. You will be the first one on.

We stand in recess then until 1 o'clock.

[Whereupon, at 11:35 a.m., the subcommittee was recessed, to reconvene at 1 p.m., the same day.]

Mr. **Anderson**. The meeting of the subcommittee will come to order.

When we had to recess for voting a while ago and then go to the emergency meeting of the full committee, we caught Mr. Love in the middle of his presentation. So you can pick up however you want to handle it, Mr. Love. Then we will ask you questions. The floor is yours.

Mr. **Love**. I want to submit to the committee a document which was included as appendix A in the 1980 draft DOE study prepared by Coburn on the alleged problem of pipeline undersizing. This particular appendix, which I have given to the committee counsel, is an eye opening document in terms of evidence of abuses against shippers. Of particular interest is a series of internal oil company documents, which are quoted from verbatim in the appendix.

The last word I would like to offer is on the Williams decision. I am not sure how familiar the committee is with the Williams Brothers case. Just a few passages from the decision will give the flavor of it. The FERC said in its order that they are setting ceilings they thought would "seldom be reached in actual practice" in terms of the rates that could be charged. They referred to the pipeline problem as "something on the order of an ingrown toenail." They adopted a rate base methodology where they admitted "rigorous logic and Euclidean consistency are not the system's most striking features" and the depreciation schedules were based on "ancient studies". They said their purpose in regulating oil pipelines is only to stop what they consider to be "egregious exploitation and gross abuse." One of the dissenting Commissioners referred to the decision as "the regulatory equivalent of Dialing for Dollars" in making reference to the way they determined allowable rate of return.

The Williams decision is clearly designed to go a long ways toward deregulation at the administrative level. Whether you call it pockets of monopoly or an industry that is basically monopolistic with pockets of competition, if you determine that in any sense whatsoever there are pipelines that exercise real monopoly power, deregulation will have an adverse effect on competition, taxpayer interest or consumers. I think the committee should not only reject the bill before it. It should also take a hard look at the FERC because the problems that the bill would create if it passed are the same kinds of problems we will see if the Williams decision is allowed to become the law of the land as far as the way pipelines are regulated.

That concludes my statement.

Mr. **Anderson**. Thank you for your presentation.

Could you elaborate on the impact that long-term contracts have in the industry?

Mr. LOVE. Well, I think that long-term contracts provide shippers more bargaining power with oil pipelines. It allows a shipper to essentially threaten to build its own pipeline, or to negotiate with another pipeline company to build a spur out to their field. So long-term contracts provide shippers with more bargaining power. They would tend to reduce the monopoly power the pipeline has.

The problem is that in order for the long-term contracts to be effective, the shippers have to, they would have to be large enough in order to be able to have real clout with the pipeline owner. And in order to be large enough, frequently they have to band together in groups. And in order to band together in groups, in some cases they have to know who all the future shippers would be.

Take, for example, the TAPS Pipeline case. You have one group of shippers right now. But 15 years from now you can have an entirely different group. Prudhoe Bay will be depleted and you will have production from other fields on the North Slope that are just now being discovered. Nobody knows who the future shippers are at this point.

And so by the time they are identified, they will have to sit down and cut their own deal. They will have to negotiate their own long-term contracts. But by that time the current pipeline operators will have already paid for their investment.

Mr. ANDERSON. There was some discussion yesterday on the impact that this proposed bill might have on the windfall profits tax. Your study indicates that vertically integrated producers can reduce this tax by charging more for the transport of oil, and so make their largest profits in transportation rather than in production.

Are you familiar with the testimony of Deputy Assistant Secretary of the Treasury David Glickman before the Senate Energy Committee last year when he said:

> The rules relating to the determination of the removal price for calculation of the windfall profits tax in all but one instance, TAPS, operates independently of other costs including pipeline transportation costs.
>
> If as is proposed in S. 166, oil pipelines are deregulated, related producer and pipeline companies would not be able to avoid the windfall profits tax by setting an artifically low removal price for crude oil and recouping the lower price by setting an artifically high rate for transportation of their oil alone.

How would you evaluate this testimony?

Mr. LOVE. I noticed that yesterday, in reading through the Association of Oil Pipelines' critique of my testimony, and I stand ready to be corrected with respect to lower 48 pipelines, if I am wrong on that point. It still does apply to the North Slope production which is addressed in the bill that is before us. I might add that the FERC has indicated an interest in applying the logic of the Williams decision to the TAPS pipeline, so it would also be an issue, if Williams is applied to that line. But I am prepared to stand corrected on the question of the lower 48 pipelines if that in fact is the case.

Mr. ANDERSON. Several Federal witnesses yesterday indicated that the impact deregulation might have on consumers was minimal. In his critique of your study submitted yesterday by the industry association they continued this theme. They cite a 1982 Department of Energy study, which you also utilized, that said that even if regulation restrained oil pipeline rates by 20 percent, the savings to the consumer was less than a half a penny per gallon. Since you also used this document and since DOE indicated yesterday that consumer costs would be minimal if all pipelines are deregualted, how did you arrive at a different conclusion?

Mr. LOVE. I don't think I arrived at a different conclusion at all. In fact, the four-tenths of a cent that was mentioned in the pipeline company's testimony is a fairly significant amount. I said the cost to consumers may be measured in terms of tens of millions or hundreds of millions of dollars. If you just apply the 0.4 cents toward the amount of gasoline that was consumed in 1981 that amounts to roughly $400 million in terms of increases to consumers. So on a percentage basis these things look small. But you are talking about multiplying this against a fairly large number.

I think in my paper I was exceedingly fair to the industry in terms of my claims in terms of the cost to consumers. I thought the issue was really the absolute dollars consumers would be paying. It certainly is true that in crude markets the incidence of tariffs is largely on the producers of oil production as opposed to consumers. But there still is an impact on consumers in some product markets.

Mr. ANDERSON. Mr. Clinger?

Mr. CLINGER. Just one question, Mr. Chairman. You have indicated some concern that if the *Williams* decision were to become the model, if you will, that that would cause some real problems. But wouldn't it be fair to say that the *Williams* decision at least in part represents a return to regulatory policies that have existed under many administrations over 50 or 60 years? It doesn't seem to me that it represents a radical departure from what has been fairly consistent policy.

Mr. LOVE. I think the effect of regulation of the oil pipeline industry from the 1940's until the 1970's was essentially a consent order that was in effect. The Elkins Act consent order of 1941 which was vacated last year. Now it is kind of tough to tell what the effect is going to be with both Williams and the consent order being vacated. The big push in the 1970's was to reform the ratemaking practice in oil pipeline rates. This really reached a crescendo in 1980 before Reagan was elected and I think it would be hard for any observer to say there wasn't a big change in the policy the following year.

So those would be my two responses. One, that it was the consent order that was the effective method of regulation to the degree there was effective regulation of pipeline rates up until the 1970's. Then in the 1970's you saw a big push for reform of pipeline ratemaking. I see this as turning back from the reforms we saw in the late 1970's.

Mr. CLINGER. Thank you.

Mr. ANDERSON. Is that it?

Mr. CLINGER. Yes.

Mr. ANDERSON. Thank you, Mr. Love, for your presentation.

We will now recess for about 15 minutes to go vote.

[Recess.]

Mr. ANDERSON. The meeting of the subcommittee will come to order.

Our next witness is Mr. Ed Mampe, director, Government affairs, of Crown Central Petroleum.

Mr. Mampe, we do have your prepared statement. It will be made a matter of the record in its entirety.

[Statement referred to follows:]

TESTIMONY OF EDWIN P. MAMPE, JR., DIRECTOR, GOVERNMENT AFFAIRS, CROWN CENTRAL PETROLEUM CORP.

Good afternoon. Crown Central appreciates the opportunity to testify on H.R. 2677, the "Oil Pipeline Regulatory Reform Act of 1983".

Crown Central is an independent refiner/marketer headquartered in Baltimore, Maryland. We own and operate a 100,000 B/D refinery located near Houston, in Pasadena, Texas, refining principally gasoline, heating oil and diesel fuel. We market our gasoline at retail in ten southern and eastern states, under the Crown, Fast Fare, and Zippy Mart brands. About half of all our gasoline and 95 percent of our heating oil and diesel fuel sold in these markets is sold to wholesale accounts: jobbers, chain retailers and commercial. We think our presence in these markets significantly enhances both competition and diversity of supply, to the benefit of consumers.

The vast majority of our refined products, 75,000-80,000 B/D, are transported through the Colonial and Plantation Pipelines. We do not own any portion of these common carriers and therefore, are classified as a "non-owner shipper". We have invested $16,036,577 in constructing 11 terminals along the Colonial/Plantation system. These have an estimated present market value of $20,700,000.

We favor minimal government interference in economic activity in competitive businesses. However, we endorse appropriate regulation when economies of scale and "sunk" costs result in natural monoply characteristics. In our view, the Colonial and parallel Plantation Pipelines share natural monopoly characteristics. While Plantation Pipeline parallels Colonial Pipeline in seven southeastern states, our terminals are not connected to both pipelines, so we do not have the option to use one pipeline or the other. To input product into Plantation requires Colonial to deliver the product from our Houston refinery to the Colonial connection to Plantation at Collins, Mississippi.

The Colonial Pipeline, stretching from its origin near our Texas refinery, to its terminus at the New Jersey side of New York City harbor, is the world's largest crude or product pipeline. While the Trans-Alaskan Pipeline is 801 miles long, with a capacity of 1.5 million B/D of crude oil, the Colonial is 1,504 miles long and has a capacity of 2.2 million B/D of products. Each day, Colonial moves about 1.7 million barrels of refined products an average distance of 1,100 miles, according to their 1981 Annual Report. Colonial reports that it transports 46.6 percent of all gasoline, kerosenes, and distillate fuel oils sold in Mississippi; 53.9 percent in Georgia; 64.1 percent in Tennessee; 49.3 percent in South Carolina; 73.4 percent in North Carolina; a staggering 81.2 percent in Virginia; 63.3 percent in Maryland; and, 116.8 percent in New Jersey, where barges are loaded for movements to New York and New England. Much of the remaining gasoline and distillates sold in the states south of Maryland is transported by the 600,000 B/D Plantation Pipeline, which has its origin in Louisiana, and terminates near Newington, Virginia.

We are concerned that deregulation of these two parallel common carrier product pipelines could result in enormous tariff increases in our market areas, given their location in the Piedmont inland portions of the southeastern states in areas that are remote from alternative water transportation. The Atlanta, Georgia market is a good example. The Colonial tariff from Houston to Atlanta (Doraville) is 1.690 cents as of June 1, 1983. Our least-costly non-pipeline alternative would be to ship product to Savannah by tanker, costing 3.230 cents per gallon; then, truck it 255 miles to Atlanta, costing another 5.418 cents, plus a thru-put at Savannah at an additional cost, which might or might not be possible for tanker quantities.

Another example is from Pasadena, Texas, to our Birmingham, Alabama termimal. Product could be moved by a 40,000 bbl. barge from Houston by coastal water up the Warrior River to Birmingham Port, at a cost of 4.762 cents per gallon. Our Birmingham terminal is 30 miles from the port. Truck-transport would cost another 2 cents per gallon. But, we have no facilities in Birmingham to off-load the barge. A thru-put agreement, if we could get one, would add probably another penny per gallon, giving a total cost of over 7 cents per gallon. The Colonial Pipeline tariff from Pasadena, Texas, to Birmingham, Alabama, is 1.457 cents per gallon.

We think that the costs of getting our products to market areas like Birmingham and Atlanta could increase so much that our competitiveness might be seriously impaired and we could no longer compete with the majors who own the pipelines. The owner-shippers of these pipelines could increase their rates significantly, pay themselves correspondingly-large increased dividends, and achieve a significantly better overall financial posture at the expense of all competing non-owner shippers who have no viable economic alternative. While we do not ascribe any conscious motive to the owner-shippers of these pipelines, their opportunity and our concern are very real.

Bear in mind that the ten owner-shippers of the Colonial Pipeline are all major oil companies: Amoco, Atlantic Richfield, BP, Cities Service, Continental, Gulf, Mobile, Phillips Texaco, and Union.

Similarly, the owners of the Plantation Pipeline are major oil companies: Exxon, Shell, and Standard Oil of California. The non-owner shippers are preponderantly independents and consumers.

In short, we believe that the cost characteristics of the parallel Colonial and Plantation Pipeline systems, which reflect low historical costs of land acquisition and construction, have significant monopoly characteristics in the sense that their cost advantage over other transportation alternatives is so great that new competing facilities would be practically and economically impossible to build. With the declining demand for petroleum products plus the urban growth which has occurred over much of the necessary right-of-way, no other parallel pipelines will ever be built to service the same areas because they could not be competitively viable with the existing pipelines which have surplus capacities. Thus, we are concerned that owner-shippers have potential monopoly power stemming from the large cost advantage that exists. There is the possibility that the owner-shipper might exercise this advantage in an unregulated world, jeopardizing both our dedicated terminals and our retail outlets.

It is our understanding that the Anti-Trust Division of the Department of Justice shares our concern regarding deregulation of Colonial and Plantation Pipelines, based on their construction of indexes of market concentration along these lines.

In this context, recalling some of the pro-deregulation studies which have been made, we consider it native analytically to lump together all pipelines in all markets, both crude and product, to then compute the average cost increase to consumers, and to say that these increases can be ignored because they are "sub-microscopic"—the term used in the recent FERC "Williams Brothers" case. We think our cost comparisons clearly demonstrate that deregulating these two large pipelines could put us out of business.

In summary, our corporate philosophy is one of deregulation where effective competition exists. Thus, we support the bill where there exist numerous alternative transportation modes that are cost competitive, but we think that clearly the Colonial and Plantation product pipeline systems should be grouped with the Trans-Alaskan crude pipeline and possible others on the basis of a lack of cost-competitive alternatives.

COMPARISON OF PRODUCT TRANSPORTATION COSTS

[In cents per gallon]

Terminal	Estimated tanker/trucking cost [1]	Terminaling cost [2]	Total cost	Colonial/Plantation pipeline tariff rate as of June 1, 1983
Elizabeth, N.J	7.62	0	7.62	2.361
Curtis Bay, Md	7.14	0	7.14	2.213
Norfolk, Va	6.83	0	6.83	2.143
Richmond, Va	7.14	0	7.14	2.071
Newington, Va	7.94	.35	8.29	2.565
Charlotte, N.C	10.33	.35	10.68	1.896
Spartanburg, S.C	10.35	.35	10.70	1.857
Columbus, Ga	8.36	.35	8.71	2.163
Doraville, Ga	9.65	.35	10.00	1.690
Birmingham, Ala	7.00	.35	7.35	1.457

[1] After expenditure for dredging and dock facilities to handle tankers.

[2] Assumes tanker to truck. Would be higher by perhaps 0.50 if tanker to tank to truck.

VITA—EDWIN P. MAMPE, JR.

Edwin P. Mampe, Jr., was born in 1941, in Wilmington, Delaware. He earned an A.B. degree in economics at Lafayette College, Easton, Pennsylvania, and an M.A. and Ph.D in quantitative economics at the University of Illinois, Urbania. He was a staff analyst in the Office of the Secretary of Defense from 1968–1970, and a senior economist concerned with energy policy issues at the Office of Management and Budget, Executive Office of the President, in 1974–1975. He was also Director, Office of Pricing Regulations in the FEA/DOE Economic Regulatory Administration from 1976–1980.

Mr. ANDERSON. Please proceed.

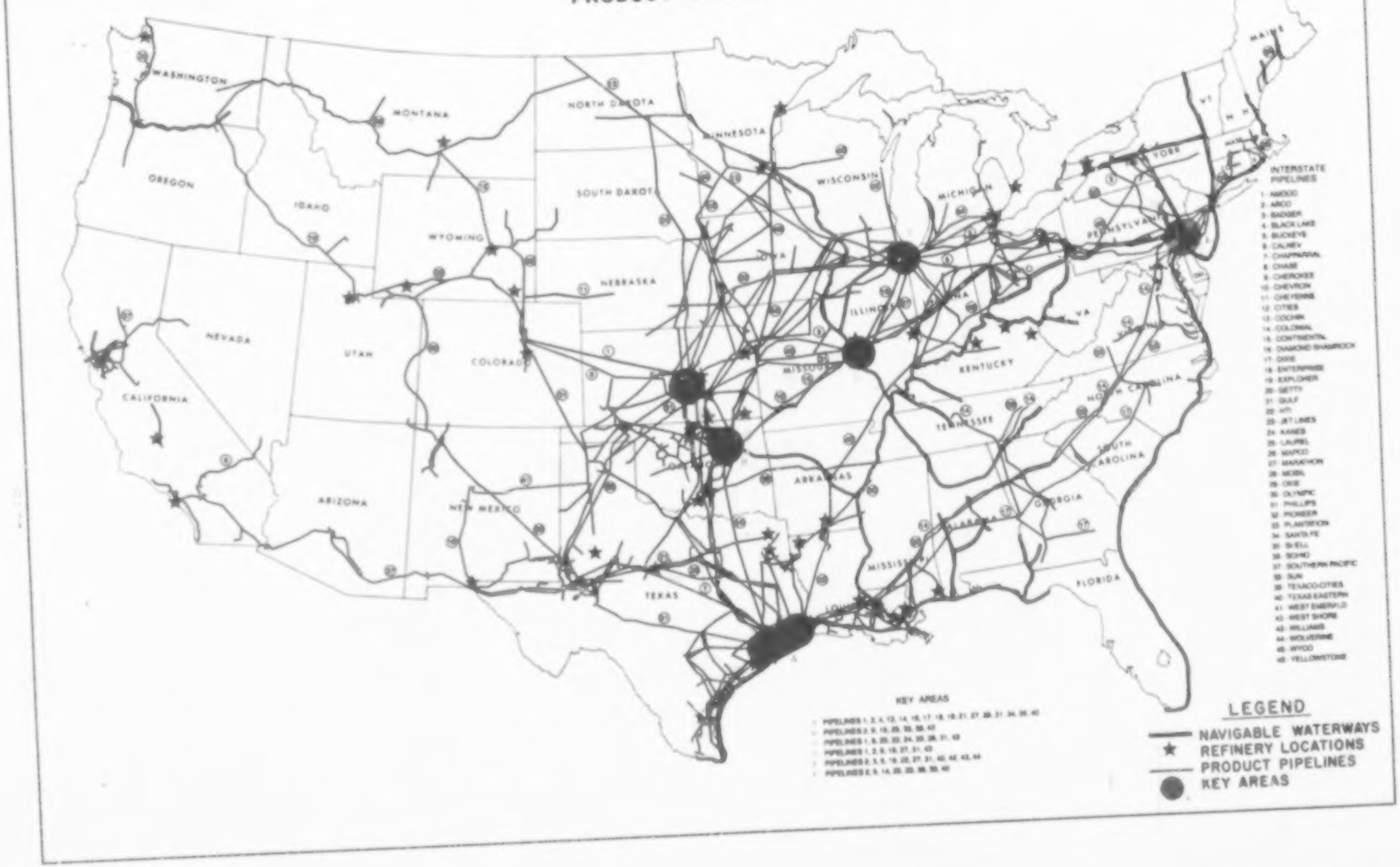
TESTIMONY OF ED MAMPE, DIRECTOR, GOVERNMENT AFFAIRS, CROWN CENTRAL PETROLEUM

Mr. MAMPE. Thank you, Mr. Chairman, we appreciate the opportunity to testify here this afternoon. I took the liberty of bringing along two maps. One is hanging over there. It is a printout of the National Atlas prepared by the U.S. Geological Survey, I believe. It is a map of product pipelines in the United States. The pink bands represent volumes of product moved through product pipelines.

You can see that the widest bands are in the southeast part of the United States.

[Map referred to follows:]

PRODUCT PIPELINES


WASHINGTON
OREGON
CALIFORNIA
NEVADA
IDAHO
MONTANA
WYOMING
UTAH
ARIZONA
COLORADO
NEW MEXICO
NORTH DAKOTA
SOUTH DAKOTA
NEBRASKA
MINNESOTA
IOWA
MISSOURI
ARKANSAS
TEXAS
WISCONSIN
ILLINOIS
INDIANA
MICHIGAN
KENTUCKY
TENNESSEE
MISSISSIPPI
ALABAMA
GEORGIA
FLORIDA
SOUTH CAROLINA
NORTH CAROLINA
VA
PENNSYLVANIA
NEW YORK
VT
N.H.
MAINE
INTERSTATE PIPELINES
1 - AMOCO
2 - ARCO
3 - BADGER
4 - BLACK LAKE
5 - BUCKEYE
6 - CALNEV
7 - CHAPPARAL
8 - CHASE
9 - CHEROKEE
10 - CHEVRON
11 - CHEYENNE
12 - CITIES
13 - COCHIN
14 - COLONIAL
15 - CONTINENTAL
16 - DIAMOND SHAMROCK
17 - DIXIE
18 - ENTERPRISE
19 - EXPLORER
20 - GETTY
21 - GULF
22 - HTI
23 - JET LINES
24 - KANEB
25 - LAUREL
26 - MAPCO
27 - MARATHON
28 - MOBIL
29 - OKIE
30 - OLYMPIC
31 - PHILLIPS
32 - PIONEER
33 - PLANTATION
34 - SANTA FE
35 - SHELL
36 - SOHIO
37 - SOUTHERN PACIFIC
38 - SUN
39 - TEXACO-CITIES
40 - TEXAS EASTERN
41 - WEST EMERALD
42 - WEST SHORE
43 - WILLIAMS
44 - WOLVERINE
45 - WYCO
46 - YELLOWSTONE
KEY AREAS
LEGEND
NAVIGABLE WATERWAYS
REFINERY LOCATIONS
PRODUCT PIPELINES
KEY AREAS

Mr. **Anderson**. That wide band on the East Coast, rather thick.

Mr. **Mampe**. That is essentially the Plantation and Colonial Pipeline system which on the other map I have represented by the black lines. There is actually a third pipeline that would be included in that amount of movement, which is a propane pipeline called the Dixie Pipeline that goes from the Gulf of Mexico. It ends up in North Carolina but it can only move propane. It is a rather small line. The preponderance of those two big very, very wide bands are the Colonial and the Plantation Pipelines.

I will endeavor to explain our system a little bit and how we are totally dependent really on those two product pipelines. On the chart to your left, the largest black tack represents our refinery. We have only one refinery. That is in Pasadena, Tex., which happens to be the origin of the Colonial Pipeline. The smaller black dots are owned terminals along the Colonial Pipeline. Along the way—the yellow dots are the Crown stations which you see in the Virginia and Maryland suburbs of Washington. We market under the Crown brand in this area.

The blue and red dots are two other subsidiaries, convenience store subsidiaries. They market under Fast Fare and Zippy Mart brands. The refinery we have is a 100,000-barrel-a-day refinery and it was designed to make gasoline. We can manufacture a capacity of about, oh, 72,000 barrels a day of gasoline. And almost everything else that comes out of the refinery is middle distillate, heating oil or diesel fuel. We don't make any so-called bottoms, residual fuel or asphalt or anything like that.

We ship virtually all of our products except for amounts we may sell in the cargo lot market in the Gulf of Mexico up either the Colonial or Plantation Pipelines. We market about half of our gasoline through our own outlets, the colored tacks on the map. The other 50 percent of our gasoline we sell to other third parties: jobbers, chain retailers—who market under their own brands, and commercial accounts. So we feel we are a substantial force for competition in this Southeast and East Coast area, because we market only about half of our gasoline at our own stations.

We sell the other half to third parties and we sell virtually all our heating oil to independent heating oil dealers. We don't market any of our heating oil ourselves.

We have invested in the terminals, $16 million of front-end money. And we estimate they are worth currently today about $20 million. We do not own any part of either of the Colonial or Plantation Pipelines, but we have invested this $20 million in these terminals which load trucks, supplied by the Colonial and Plantation.

We are therefore classified as nonowner shipper. We are probably a classic example of a nonowner shipper.

The magnitude of these lines I don't think is generally perceived. The Colonial line has a total capacity of 2.2 million barrels a day. That compares to the Trans-Alaskan Pipeline capacity of 1.5 million barrels a day.

Colonial is also much, much longer than the Trans-Alaskan Pipeline. It is 1,504 miles long and the Trans-Alaskan is 801 miles long. So in terms of ton-miles, if you read Colonial's 1981 report, I believe they say that they account for 40 percent of the total ton-miles of all movements of oil, both crude and refined petroleum products. That is just the Colonial system.

The Plantation system, which is a 600,000-barrel-a-day system, which begins in northeast Louisiana and ends right over here at Newington, Va., is another very, very major pipeline. As you can see, they are parallel pipelines and they both supply the same markets. They are interconnected at a crossover terminal in Collins, Miss. And if Crown wants to supply one of its terminals, for instance, at Newington, Va., we are only connected to the Plantation Pipeline. If we desire to move our refined gasoline or middle distillate from our refinery in Texas, we have to first put that into the Colonial line, then ship it up to the crossover point at Collins, Miss. There it enters into Plantation, and we move it up to our Newington terminal and load trucks which supply the Crown stations.

So that is a summary of how we move our products logistically.

Also quoting the Colonial Pipeline 1981 Annual Report, they have an enormous share of the market in this area. This is Colonial alone, not including Plantation. On page 2 of my prepared statement I mention that Colonial says it supplies 46 percent of all gasoline, kerosene, and distillate fuel oil sold in Mississippi, almost 54 percent in Georgia, 64 percent in Tennessee, 49 percent in South Carolina, 73 percent in North Carolina, a staggering 81.2 percent in Virginia, 63 percent in Maryland, and 116 percent in New Jersey where barges are loaded and product is moved to New York and New England.

In fact, we market on Long Island, N.Y. We have, I believe, 28 or 29 gasoline stations. We actually load barges at Elizabeth, N.J., and take them over to Long Island and load trucks there and supply our Long Island, N.Y., stations.

It is rather interesting, just as an aside, that we are a significant user of Alaskan North Slope crude oil, maybe 25,000 to 30,000 barrels a day right now. When you think about the enormous distance that the oil has to move and that it can be done so efficiently is really, I think, an engineering tribute to the people who design these various systems. So technically you know they are really very, very magnificent systems.

Mr. ANDERSON. How do you get the Alaskan oil there?

Mr. MAMPE. We actually buy it from third parties. But it basically comes by tanker from Valdez, Alaska, down to the Panama Canal. There is a pipeline now across Panama. Then another tanker takes it up to the Houston Ship Channel; our refinery is on that channel, and there are also pipelines that go down to the Gulf of Mexico. We are about 40 or 50 miles from the Gulf of Mexico.

Our concern is that these systems are so large and so efficient that the costs of the next best alternative is very much more expensive than the Colonial or Plantation system. And I have prepared some examples of that. On the top of page 3 I mention the Atlanta, Ga., market. The Colonial tariff from Houston to Atlanta is 1.69 cents as of June 1, 1983. Our least costly nonpipeline alternative would be to ship product to Savannah, around Florida up to Savannah. We would then have to truck the gasoline or heating oil 255 miles to Atlanta, which would cost, based on published tariffs, another 5.418 cents, plus a throughput at Savannah.

We don't have a terminal that could receive the barge or tanker at Savannah, so we would have to pay somebody else to essentially rent his terminal to move the product through there, which might or might not be possible for tanker quantities. Some terminals don't have enough tanks, so you would have to load a smaller barge. That would be somewhat more costly per barrel of product. I might add that under the Jones Act of 1920, these tankers are required to be built in the United States and moved by U.S. crews. So the cost of moving via water in the coastal trade is probably two or three times as expensive as moving in foreign-flag vessels, perhaps from Caribbean refiners where they can use foreign-flag vessels.

Another example is to our Birmingham, Ala., terminal. We could move product by barge. A 40,000-barrel barge could be moved from Houston to Birmingham Port at a cost of 4.762 cents per gallon. Our Birmingham terminal is 30 miles from the port. We figure truck transport would cost another 2 cents per gallon, but we have no facilities at Birmingham to offload a barge. A throughput agreement, if we could get one, would add probably another penny per gallon, giving a total cost of over 7 cents a gallon.

The Colonial Pipeline tariff from Pasadena, Tex., to Birmingham is 1.457 cents per gallon, so it is more than 5 cents differential. Our concern is that the costs of getting our products to market areas like Birmingham and Atlanta could increase so much that our competitiveness might be seriously impaired and we could no longer compete with the majors who own the pipelines. The owner-shippers of these pipelines could increase their rates significantly, pay themselves correspondingly large increased dividends, and achieve a significantly better overall financial posture at the expense of all competing nonowner shippers who have no viable economic alternative. While we do not ascribe any conscious motive to the owner-shippers of these pipelines, their opportunity and our concern are very, very real.

Bear in mind that the 10 owner-shippers of the Colonial Pipeline are all major oil companies: Amoco, Atlantic Richfield, BP, Cities Service, Conoco, Gulf, Mobil, Phillips, Texaco, and Union. Those are the owners of Colonial. The owners of Plantation are Exxon, Shell, and Standard Oil California. In areas like this, we have Crown stations right across the street from Exxon, Shell, Gulf, Mobil stations. And that is something we are constantly aware of.

In short, we believe that the cost characteristics of the parallel Colonial and Plantation Pipeline systems, which reflect low historical costs of land acquisition and construction—they were built decades ago, have significant monopoly characteristics in the sense that their cost advantage over other transportation alternatives is so great that new competing facilities would be practically and economically impossible to build.

With the declining demand for petroleum products plus the urban growth which has occurred over much of the necessary right-of-way, no other parallel pipelines will ever be built to service the same areas because they could not be competitively viable with the existing pipelines which have surplus capacities, because of the national decline in the demand for products. Thus, we are concerned that owner-shippers have potential monopoly power stemming from the large cost advantage that exists. There is the possibility that the owner-shippers might exercise this advantage in an unregulated world, jeopardizing both our dedicated terminals and our retail outlets, and our sales to the independents which are important to us.

It is our understanding that the Antitrust Division of the Department of Justice shares our concern regarding deregulation of Colonial and Plantation Pipelines, in the study you will be receiving, based on their construction of indexes of market concentration along these lines.

In this context, I think it is useful to mention some of the proderegulation studies which have been made which we consider naive analytically when they lump together all the volume, through all the pipelines and all markets, compute an average increase to consumers and then say the increase can be ignored because it is submicroscopic which was the term used in the recent *Williams Brothers* case.

In the attachment I have computed costs of alternative water/truck transport to various of our terminals along Colonial and Plantation. And the added increased cost is in the range of 5 to 8 cents per gallon. We make substantially less than a penny a gallon on our refined petroleum products from refining to retailing. There is no possible way that we could absorb increases of those magnitudes.

In summary, our corporate philosophy is one of deregulation where effective competition exists. Thus, we support the bill where there exist numerous alternative transportation modes that are cost competitive, but we think that clearly the Colonial and Plantation product pipeline systems should be grouped with the Trans-Alaskan crude pipeline and possible others on the basis of a lack of cost-competitive alternatives.

Mr. ANDERSON. Thank you, Mr. Mampe, for your statement.

Mr. Mampe, the import of your statement seemed to be that you favor deregulation only in certain circumstances, where those circumstances clearly warrant continued regulation of TAPS and Colonial and Plantation Pipelines, is that correct?

Mr. MAMPE. I would say that that is a fair statement, Mr. Chairman, based on our analysis. We really haven't looked at TAPS and would not make any public statement about TAPS as a corporate matter but in terms of Colonial and Plantation we feel that in particular the Piedmont area, the northern part of Alabama, Georgia, South Carolina, there are no refineries. There are really no refineries that make gasoline from Mississippi—well, there is a very large Chevron refinery in Mississippi but there are no refineries to speak of in Alabama, none in Georgia, South Carolina, North Carolina. There was one Amoco refinery in Yorktown, Va., which probably only supplies enough product to meet maybe 20 percent of the Virginia market.

So we feel there is no effective alternative source of supply in those markets except those two very large pipelines.

Mr. ANDERSON. The Independent Gasoline Marketers Council on postenactment of H.R. 2677. It seems to me that you at least partially agree with the council. At the same time you partially disagree. That you favor deregulation where effective competition exists. I believe you are an independent marketer.

Mr. **MAMPE**. Yes, sir.

Mr. **ANDERSON**. Do you favor enactment of H.R. 2677 on a limited basis? That is, where there is effective competition for transportation of oil?

Mr. **MAMPE**. I think our preferred position would be to—we feel there are oil pipelines in the country that are sufficiently competitive that they could be deregulated. We think that the approach that seems to be inherent in the Justice Department analysis, that is to compute indexes of market concentration based on how many alternative viable sources of supply that there are there, could be used to fashion a bill that would deregulate perhaps many, many oil pipelines through a formula.

We think that the same method of constructing a formula would suggest that these two lines in particular would not be deregulated.

Mr. **ANDERSON**. If you favor selective deregulation, what kind of criterion should be used for determining the presence of effective competition in order to selectively deregulate?

Mr. **MAMPE**. I think an excellent way of doing that is the Hierfindahl, I think it's the Hierfindahl-Hirschman Index, which essentially looks to how many viable suppliers there are in a market. Basically you take the fractional shares of the suppliers, and then you square them and multiply by 10,000. So if there is only one supplier in the market, which would be true in much of this area on the map, you have a Hierfindahl Index of 10,000, which is a perfect monopoly.

If you have 10 suppliers and they each have 10 percent of the market, you square those point ones, and you have a value, add them all up and you—multiply by 10,000, you have a value of 1,000. That is a highly competitive market in institutional economics.

Basically it seems to us a viable approach to compute the Hierfindahl Indexes and deregulate those by rule that would perhaps be under 3,000, or take some arbitrary number, and do that through an administrative rulemaking. We think that is a very viable way to go.

Mr. **ANDERSON**. Mr. Clinger?

Mr. **CLINGER**. Thank you, Mr. Chairman.

I take it you are saying that the Colonial/Plantation Pipelines are not really competitive and therefore require continued regulation, is that it?

Mr. **MAMPE**. We are concerned that the tariffs could go up 3, 4, 5, 6 cents per gallon. And given that cost base possibility, how would these increases be passed through? If in fact all these increases were passed through to consumers, that would have a very slight anticompetitive effect on our company. But the other possibility that we really worry about, let us say that the stated tariff, and both of these by the way are joint ventures. So the tariffs are set by the various partners and there is only one tariff. It is different than the Trans-Alaskan Pipeline.

Let us say that they decided with deregulation that the tariff would go up 4 cents a gallon. Well, any one of those 10 partners in Colonial or 3 in Plantation has the option of saying, "Well, instead of raising my prices at the pump or terminal I will just go up, let's say, 2 cents a gallon," because really the increase in the tariff for an owner is just an internal transfer.

And what if one of the owners decided, "Well, I'll set a price for heating oil at my rack to independent heating oil dealers 2 cents less than Crown Central." We could not sustain that kind of competition for any length of time, and we would lose, we think, that type of business.

Mr. **Clinger**. What portion of the industry do you feel may be noncompetitive, thereby requiring the need for rate regulation?

Mr. **Mampe**. What portion of the product pipelines?

Mr. **Clinger**. Yes, overall.

Mr. **Mampe**. We have really not looked in great detail—Well, we have not looked at all the pipelines in the country. We are a shipper in several other pipelines in mid-continent. Those areas did not give us the same concern that we have about Colonial and Plantation. One of them that we ship through roughly parallels the Mississippi River. You can bring—there are refineries along the Mississippi River. You can bring in foreign flag tankers carrying crude oil and so there is, in our view, a much more viable competitive system in other parts of the country than in this Piedmont area of the Southeast and East.

Mr. **Clinger**. So this is really the only area where you feel directly threatened?

Mr. **Mampe**. That is correct; yes, sir.

Mr. **Clinger**. What would be your position as to the retention of antidiscrimination and common carrier provisions for oil pipeline regulation?

Mr. **Mampe**. That is an area where I don't pretend to be an expert. But I did hear some of the discussion yesterday morning at the hearing. And the thought did occur to me, if a carrier has the ability to price discriminatorily, I wonder if the other provisions really would be very helpful, because if there is no protection against discriminatory pricing, conceivably the owners of the system could decide to have separate rates for everybody else it would seem to me. And then we wouldn't have any protection whatsoever.

Mr. **Clinger**. Thank you very much.

Mr. **Anderson**. Thank you, Mr. Mampe, for your presentation.

Mr. **Mampe**. Thank you.

Mr. **Anderson**. Our next witness is Mr. Jack Blum, Independent Marketers Council.

Mr. Blum, the full text of your prepared statement will appear in the record at this point.

[Statement referred to follows:]

Prepared Statement of Jack Blum, General Counsel on Behalf of Independent Gasoline Marketers Council

My name is Jack Blum, I am the General Counsel of the Independent Gasoline Marketers Council, a trade association of non-branded independent retailers of motor gasoline. Council members are shippers on major product pipeline systems and those who are not depend on those systems for the delivery of supplies.

We strongly oppose H.R. 2677 which, in our view, would as a practical matter remove all government regulation of oil pipelines. It would create opportunities for shipper-owners of pipelines to drive their independent competitors out of business, allow the owners of pipelines to control crude oil prices and limit competition, and allow them to avoid paying Federal and state taxes and royalties.

We think that if there is to be pipeline legislation, it should be reregulation. The FERC decision in the *Williams Brothers* case was a statement by FERC that it lacked both the will the intelligence to enforce existing law to protect the interests of pipeline customers and the American public. Congress should tell FERC in no uncertain terms that pipelines which are natural monopolies must be rate regulated in classic public utility fashion and should order it to get to work.

So that the discussion is not abstract and so that you understand exactly what our concerns are, I will put them in the context of the three pipelines which are most important to the survival of independent marketers. All three are natural monopolies and all three are shipper owned. The Colonial and Plantation pipelines are product pipelines serving the South Central and Mid-Atlantic states. The Trans Alaskan Pipeline System is, as you know, the crude pipeline which carries Alaskan North Slope Crude to Valdez. Independent access to the Colonial and Plantation systems on an equitable basis is essential to the ability of independents to provide vigorous competition in Alabama, Georgia, the Carolinas, Virginia and Maryland. The cost of the shipment on the pipeline has for many years been half the rate of comparable water borne transportation to those destinations with deep-water terminals. For other inland destinations, there is literally no competing transportation system. The next best available transportation alternative, trucks and rail cars, are completely non-competitive for shipments over 200 miles.

When rates are regulated and shipper status is granted on a fair and non-discriminatory basis, independents can make use of available capacity in the product lines to buy gasoline at the Gulf Coast refining centers and ship it to independent terminals along the pipeline. The gasoline market on the Gulf is the nation's most competitive and both independent and major refiners bid for customers. By going to the Gulf market, an independent can buy gasoline at a favorable price.

When shipper-owners pay the same price as the independents for the transportation and that price is related to fair return on investment, the shipper-owners have had no unfair advantage and independents can compete with them head to head.

When there is no rate regulation, shipper-owners can benefit from rate increases which destroy their competitors. This means that without rate regulation non-discrimination clauses are worthless.

If a proposal such as this one passes, or if the *Williams Brothers* decision is implemented, independents will be confronted with the need to pay direct competitors a surcharge for the privilege of moving product to market. By raising the pipeline tariffs, major shipper-owners such as Exxon and Gulf will be able to control the retail pricing behavior of independent shippermarketers. If independents find low priced products and begin to cut retail prices, a tariff increase will force their prices up. There will be no cost change for shipper-owners because they will pay the increased price to themselves as dividends. Similarly, major shipper-owners will be able to control market entry by making product too expensive to be competitive in markets where their own retail outlets are concentrated.

Lest you think these problems are invented, I offer for the record documents obtained by the Federal Trade Commission in *In re Exxon, et. al.* These documents include portions of a Gulf memorandum evaluating its position on pipeline expansion which spells out precisely the competitive considerations I have outlined.

The impact of the recent FERC decision in the *Williams Brothers* case and the complete disinterest of FERC or the Justice Department in acting to prevent non-discrimination among shippers has already led to significant tariff increases on the Colonial system. In the past, the Courts had held that when a shipper-owner charged an overly high tariff for shipments on the line which produced a return above that which was fair and reasonable, it constituted rate discrimination under the Elkins Act. In effect, the Courts said the shipper-owner was giving himself a rebate not available to non-owners. With the dismissal of the consent decrees in *U.S.* v. *Atlantic Refining Co., et al.* (Dec. 23, 1941) (Cir. 14060 D.C.D.C.) this constraint on tariffs was removed.

The *Williams Brothers* case propounded a novel and bizarre theory of utility rate making. It advances the concept that the "rate base" is the current market value of the pipeline, that depreciation should not be taken into account, and that leverage should not be taken into account in computing return on equity. The gratuitous comments in the opinion about "no public interest in pipeline rates" and about the stupidity of everyone connected with the breakup of the Standard Oil Trust confirm the ideological singlemindedness of the FERC majority.

If any other natural monopoly were regulated *Williams* style, consumers would be priced out of essential services. Electricity would be twenty times its present cost. There would be no universal natural gas or telephone services and private water companies would set prices based on the cost of a six pack of beer at the supermarket.

Clearly the members at FERC are not serious about having a public mission and believe that the only interest they serve is that of the owners of major pipelines. I wish to make it plain to every member of this committee and, albeit indirectly, to FERC that there are others of us in the industry besides the pipeline shipper-owners and there is a rest of the country out there which will gradually come to understand the cost of giving billions of dollars to major oil company shipper-owners without public benefit or coherent rationale.

If all wraps are taken off all the Colonial and Plantation pipeline systems, I predict sharp increases in the price of gasoline in the Southern and Mid-Atlantic regions and a diminution in the numbers of independent marketers and independent refiners.

The other issue of enormous concern to independent marketers is the tariff schedule of the Trans Alaskan Pipeline. We believe that the TAPS line must be regulated. We believe that the tariffs which have been filed to date are ludicrous and represent substantial overreaching by the companies involved. The high tariffs have a devastating impact on the rest of the industry, the federal treasury, and the State of Alaska.

First, exploration and development in America's largest new petroleum province is now essentially limited to owners of the pipeline. Any independent who wants to bill on a lease will wind up giving his profits to the pipeline owners. This means that the bids on Federal and State lands on the North Slope will be significantly lower than they otherwise would be because only insiders can play. The cost to the Treasury in lost bid receipts is billions of dollars.

Second, keeping independent companies without an interest in TAPS out of Alaskan development will further diminish the already limited competition in West Coast crude oil markets. There is a strong circumstantial case that the West Coast crude oil market is rigged by the major companies to minimize tax payments and minimize the amount paid to independent producers. Some of the issues to which I am referring are already in litigation in the Federal Court in Los Angeles in the *Long Beach* case other of these issues are being carefully examined by California independent producers, independent refiners, and the Internal Revenue Service.

The Internal Revenue Service and the federal government have by far the largest state in the TAPS issue. By increasing the transportation costs for carrying Alaskan North Slope crude to market, producers on the North Slope are able to lower the wellhead price for the Alaskan crude they produce. This is because the wellhead price is based on a net-back system from the end market. Transportation charges are subtracted from the end market price to determine the wellhead price which sets the windfall profits tax and state royalty payments.

With respect to crude from the Sadlerochit Reservior, the impact of increasing transportation "costs" by a dollar is to save 91¢ in Federal windfall profits taxes and State royalty and severance taxes. The failure to regulate the rate on the TAPS pipeline is a direct give-up of government revenue. Deregulation will make paying taxes and royalties optional.

At least one of these oil companies has cheerfully used government subsidies provides by the inflated tariffs to destroy competitors. The company to which I refer is Arco, which has subsidized retail gasoline prices in selected markets to drive our independent competition.

The price of this game is in the billions. The Justice Department in a recent filing in the TAPS case at FERC estimated the government losses so far at $15 billion.

We as a group, are tired of the government generously giving our major competitors a subsidy which it can use to run us out of business.

Its time that this committee understood that the rhetoric about deregulation does not stand up to examination where monopoly pipelines are involved and, in this case, it is a smoke screeen for transferring billions of dollars from the Federal Treasury to the pocket of oil company owner-shippers and is a tool for the elimination of significant price competition.

What I find almost impossible to understand is the arrogance of companies who have already persuaded FERC in the *Williams Brothers* case to give them a virtually unlimited rate of return in coming to Congress to ask for even more complete deregulation.

Members of the Committee who represent producing states should be aware that the bill under consideration will also preempt all state regulation of pipelines in inter-state commerce. Given the definition of inter-state commerce, this will mean the deregulation of most intra-state lines including crude gathering systems.

If this approach is adopted, the ability of state regulatory agencies to establish a pro-rating system will be destroyed inasmuch as it will be impossible for state agencies to require the purchase of all oil in a field on a pro-rated basis. Congress will thus deprive independent producers of state protection against the monopoly power of the majors.

If you have any questions, I will be glad to answer them.

Mr. ANDERSON. Please proceed.

TESTIMONY OF JACK BLUM, INDEPENDENT GASOLINE MARKETERS COUNCIL

Mr. BLUM. Thank you, Mr. Chairman. I appreciate the opportunity to testify here today. You have entered the full text of my prepared statement into the Record. Rather than repeat it, I will highlight several of the points because I think much of what I have had to say is covered, by my statement or has been covered by other people who have testified here this morning.

I would like to begin by saying my group has people all over the country. What seems to happen is people say do you favor deregulation where there is competition? Everyone says sure. Then we ask about their own particular home market and they all can think of a situation in their home market that says no, I think in my market I can't have it but may over there there is a situation, so I would favor it over there. I will give you some examples.

The city of Las Vegas is served by a single pipeline coming out of California. If you are an independent and can't get product off that pipeline, you have got a real problem. If you are faced with a high tariff situation, you have got a real problem. Similarly, there are single pipelines through the Northwest and Intermountain area. Those are life and death affairs for independent marketers.

Why are we concerned about it? Well, we have two problems. The first problem is one of access. And here I note that Mr. Clinger asked several questions about should we retain antidiscrimination provisions if we deregulate. We maintain that rate and antidiscrimination are two pieces of the same thing. And that was made very plain by the case which, in effect, was the rate regulation case for many years which were the Elkins Act cases and the Elkins Act consent decree.

The reason is simply this. If an owner/shipper raises his own rates, in effect, he can discriminate in his own favor. So if I am the owner of a pipeline and I charge 10 cents to ship a product from here to there, and then I raise the rate to 20 cents, I can pocket the 10 and keep my prices down. In effect, I am favoring my product over the poor guy who now pays the posted tariff of 20. That was the logic of Elkins Act regulation.

So to say that we are going to deregulate the rate but then prevent discrimination simply put us back in the same Elkins Act business we were in before, presuming somebody wishes to enforce the law. So our feeling is that that begs the question and what we really have to look at is, do we want to say, yes, we will deregulate. But we have to get rid of the owner/shipper, that is to say, divest. Then we have to ask the question, what about these pipelines and how should they be regulated? Our contention is that they ought to be regulated as public utilities. We should go back to a just and reasonable rate of return, and that the consequences to the consumer are not at all what FERC said in the Williams Brothers decision but rather more dramatic.

A penny on a gallon of gasoline in the course of a year is $1 billion to the American consumer. You can multiply it on out. We calculate that the analyses that have been made only relate to the cost of a small increase in the tariff. They don't take into account the dimunition of competition or any of the other effects that raising tariff and diminishing entry in product markets would bring about.

Our concerns are not academic. I attached, and unfortunately didn't have very many copies of this document to give you. I attached to my statement a submission from the Exxon case, the FTC received in the Exxon case. If you go through that carefully, you will find that Gulf Oil in that submission discusses the competitive factors that way in its decisionmaking as to whether or not to expand the line and what the tariffs ought to be. They weigh and balance very carefully the competitive impact of independents who might be able to ship on the line. And should we expand the line, because if we do it means more competitors. More independent competitors will come into the market.

So what we are telling you is not academic. Now, we feel the lines most important to our survival are TAPS on the one hand, because the TAPS system as it is now structured, and Congressman Bedell laid it out very well this morning, provide an opportunity for ducking tax money and putting the people on the Alaskan North Slope in the monopoly position with respect to 20 percent of America's crude oil supply, and then in essence avoid paying windfall profits tax on it. And then using the resulting profits and product to run us out of the markets they want us out of.

We feel that that situation has to be cleaned up. It has to be dealt with. There is a 91 cent, not the 70 cents that Mr. Bedell talked about but when you take the State of Alaska and the windfall profits tax together, 91 cents on every dollar difference between paying the tax at the wellhead, and then shifting it over to the transportation.

Now, on the transportation you would pay the nominal tax rate the company pays the Federal Government generally. We have looked at some of the analyses that have been put out. The Department of Energy has one in terms of analyzing the taxes paid by major oil companies. The rates for some of these companies are as low as 18 and 19 percent. So the marginal rate of tax drops from 91 to 18 or 19 by shifting from the wellhead to the transportation. We think that has to be brought under control, and the taxes have to be appropriately applied.

Finally, we have a very serious problem with what happens to people in the crude oil business. Our concern about that is that many of our members live on the product produced by independent refiners. If they have problems with crude oil, we have problems with product. We are very concerned that the way you have structured this legislation would hurt independent producers significantly, because as we read it, it would deregulate gathering systems in a way which would permit selective purchases from a given field in which independents could be forced to the wall and independents could be discriminated against.

We think that you have to be extremely careful about language such as deregulating pipelines in interstate commerce, because virtually every gathering system would be in interstate commerce. I think what you would want to say would be interstate transportation. I am sure you don't mean to set aside all the State regulation and prorationing, and requirements that purchases be made on a prorated basis from fields.

I think that those are the major concerns we have. I can assure you that if this bill progresses further you will see other associations representing independents here to talk about it. I know they are very upset. I know my members are very upset. As I say, they are all willing to consent to deregulating that which is competitive. Yet when you get case specific in their own market, they say, "Wait a minute, that must be somewhere else," because they think about a particular terminal, a particular pipeline and say, "Hey, it can't be me."

Mr. ANDERSON. Thank you for your statement. Yesterday witnesses from the administration testified that they were developing a proposal that would totally deregulate oil pipelines except for TAPS and pipelines having monopoly power. I realize neither you nor any of us have seen the proposal. However, would you care to comment on the general theme of that proposal?

Mr. BLUM. Well, again I agree with Mr. Mampe about Colonial and Plantation. That is 40 percent of the pipeline business. You take TAPS, that is another very substantial chunk of the pipeline business. Then if you take a look at that map and some of the regions and areas in Washington and Oregon, Nevada, up into the Intermountain West, and start asking yourself about just which of these highly competitive situations that they will deregulate, you come up with some pipelines in the Midwestern portion of the United States.

It may very well be that something can be done in some markets there. But I submit what they ought to be working on is a reverse. That is, a bill that directs FERC to get this business regulated on a fair and reasonable rate of return basis. Not 100 percent of equity every year. That is nonsensical.

Mr. ANDERSON. How do you rate policies established by the *Williams* case, or how do the rate policies established by the *Williams* case differ from those established and practiced by the ICC?

Mr. BLUM. The *Williams* case was really the final straw in the situation. As far as we are concerned the ICC was not the operative rate regulator. The operative rate regulator was the Justice Department's discrimination case. And that was what held pipeline tariffs under some degree of restraint. What we are seeing now, though, with the *Williams Brothers* case is, after the dismissal of the Elkins decree, literally an invitation to open season.

The thing that is particularly disturbing is this. We have a declining gasoline market which means capacity should be opening up on these lines. If that is the case, you would expect competitive rates to decline. They are not declining, they are going up. We think that the *Williams Brothers* case simply is put together by a bunch of people who ideologically are opposed to the law that they are trying to enforce, who have no concern at all for the public interest and minimal understanding of the industry.

I think they have to be redirected and given very specific statutory instruction. I agree with Congressman Bedell that it shouldn't have taken them very long to deal with the TAPS question.

Mr. ANDERSON. On page 7 of your statement you state at least one of these oil companies has cheerfully used Government subsidies provided by the inflated tariffs to destroy competitors. The company to which I refer is Arco, which has subsidized retail gasoline prices in selected markets to drive out independent competition.

Could you relate to the members of the subcommittee how this was accomplished?

Mr. BLUM. Well, what happened was this. ARCO announced about, now it is over a year and a half ago, a new policy that was getting rid of credit cards, it was going to increase its volume and begin marketing as an independent would. That is a matter of very limited concern to my members because we have always marketed that way, and we know that our operating costs in a given situation are extremely low.

What began to happen, though, was the price began to fall. First it fell below the going wholesale price in the market. Then it began to get very close, I am talking now about the price of gasoline, it began to get very close to the price of crude oil. We have actually reached a situation in several markets where several of my members joked about putting together a new kind of facility in the oil industry. They talked about a reverse refinery. Go out and truck all the products to this one place and then put it together in a pot and reconstitute the crude oil because the difference between product price and crude price was enough to make that profitable.

We began to wonder what was going on here. How can some guys hit this market with product that is practically at or below the cost of crude? You have to then go back and say what is going on? We started looking very carefully at the transfer pricing system and the tax system. And when you get into that you begin to start looking at the tariff and the method by which wellhead prices are calculated. And what we discovered lately and we only come to it lately after that competitive situation broke out, because we didn't really have a reason to look, was that the State of Alaska is dead right. That their contentions about what is going on are exactly right, only one of the companies has chosen to take that money and use it in a downstream way that is going to run us off the reservation.

The further point is that on the Alaskan North Slope there could be real competition in crude oil if this line were properly regulated. There are independents with a capacity to go up here and drill. There are other potential suppliers of crude oil. But as long as they can't get into the loop and can't play the tax game the way other people can, can't play the royalty game, the Government is going to lose out on bid money and independents are simply not going to go up there because by the time they drill a well and ship that oil down to the Lower 48, there won't be any profit in it.

Now, I talked to OMB about the problem and I suggested that if they really thought some of these lines could be deregulated, maybe one solution would be to let the Government take a fair market rental for the right-of-way from the company, after looking at the kind of profit the company took from a pipeline. Of course that didn't get very much attention from anyone. But I think it suggests to you exactly what the problem in this case is.

Mr. **Anderson**. Mr. Smith?

Mr. **Smith**. Thank you, Mr. Chairman.

With respect to the competitiveness factor in oil lines, would you agree that the coast lines would be the most competitive, with the opportunity for barge traffic, than probably the inland waterways? Or would you not?

Mr. **Blum**. Well, historically because of access to Colonial and Plantation lines, Georgia, the Carolinas have been hotly competitive. Those have been typically the most competitive along with markets such as Los Angeles where there are refineries and production in place on the spot. So those are by and large the most competitive markets.

Mr. **Smith**. Thank you.

Mr. **Anderson**. Mr. Shuster?

Mr. **Shuster**. No questions, thank you.

Mr. **Anderson**. Thank you very much, then, Mr. Blum, for an excellent presentation.

Mr. **Anderson**. Our next witnesses are Mr. Richard J. Barber, economic consultant, Trans Alaska Pipeline, and Mr. Kenneth Fountain, general counsel, Exxon Pipeline Co.

I have the prepared statement by Mr. Richard Barber here.

And I also have an assessment study by Richard J. Barber and Associates included with his statement. And, the prepared statement of Mr. Fountain.

[The full text of your prepared statements will appear in the record at this point.

[Statement referred to follows:]

STATEMENT OF RICHARD J. BARBER, RICHARD J. BARBER ASSOCIATES, INC., APPEARING ON BEHALF OF AMERADA HESS PIPELINE CORP., ARCO PIPE LINE CO., EXXON PIPELINE CO., MOBIL ALASKA PIPELINE CO., PHILLIPS ALASKA PIPELINE CORP., SOHIO PIPE LINE CO., AND UNION ALASKA PIPELINE CO.

Mr. Chairman and members of the committee, my name is Richard J. Barber. I am President of Richard J. Barber Associates, Inc., a Washington-based firm that provides economic consultation to business and government.

The specific subject of my testimony is the role and extent of competition and market factors as they relate to transportation of oil by the carriers who operate via the Trans-Alaska Pipeline System (TAPS). In 1982, my firm studied the pertinent competitive situation and prepared a report, which we have recently updated. Copies of this report, updated in certain respects, have been made available to the Subcommittee. I would ask that a copy of our 35-page report be included in the hearing record to accompany my testimony.

In summarizing our findings, let me initially say that I agree with the views of other witnesses who are appearing in these hearings and who have concluded that U.S. oil pipelines are subject to widespread competition and that their continued economic regulation is neither necessary nor desirable. Our study that what is true generally of competition in the U.S. as it relates to the oil pipelines is also true of the Trans-Alaska Pipeline System (TAPS). Completed in 1977, at a cost of $9 billion, for the purpose of transporting oil from the Alaska North Slope (ANS) to a terminal at Valdez, TAPS is a unified physical entity but involves the operations of eight separate and independent carriers. These carriers establish their own rates and transport oil for the various ANS shippers, some of whom are unaffiliated with the pipeline owners.

Since the ANS crude oil transported by the TAPS carriers competes in U.S. end-use markets with an abundance of oil from other domestic and foreign sources (moved by diverse pipelines and transportation modes), its delivered price—inclusive of the cost of transportation via TAPS—is constrained by market forces. This is true of Alaska North Slope oil delivered to West Coast refineries (where it competes with oil from California and from foreign countries) and to Gulf Coast refineries (where it competes with oil from Texas, Louisiana, and various foreign countries, including Mexico—which has substantially expanded its oil shipments to the U.S.). The delivered price of oil from these alternative sources establishes the delivered price to which ANS oil, moved over TAPS, must conform. Thus rates charged by the TAPS carriers have no effect on the price of oil paid by U.S. consumers.

Long-run considerations also shape the competitive setting. The TAPS pipeline, built to serve the Prudhoe Bay Unit, has an anticipated service life that will extend well into the next century. While the investors plan to amortize its cost over a comparable period, they can do so only if they have an adequate supply of oil to transport. However, output from the Prudhoe Bay unit itself is expected to begin to decline markedly in the late 1980's, reaching an estimated volume of only 300,000 barrels per day by the year 2000. This figure is equal to only a fifth of the current volume transported by the TAPS carriers. Since December 1981, oil has flowed from the Kuparuk Field adjacent to the Prudhoe Bay Unit, but volumes moving from it over TAPS will only partially offset the decline in Prudhoe Bay Unit production. Further, decisions by ANS producers as to whether to begin development of offshore site in the Beaufort Sea are still pending. It is thus in the interest of the TAPS carriers, aware of the many years required to develop new oil reserves, to maintain rates in the short-run that will encourage exploration that offers the potential of generating traffic in the 1990's and beyond. These vital long-term considerations also help keep the rates charged today by the TAPS carriers at reasonable levels.

The competitive and related factors which I have summarized (and which are dealt with at greater length in the accompanying report) obviate the need for continuing regulation of rates charged by the TAPS carriers. With decontrol the TAPS carriers will remain constrained in the rates they charge by competition from other oil in destination markets, by their long-term need to encourage the development of oil they can transport, and by potential competition from Alaskan on-shore or offshore oil that could be shipped by new pipelines or by marine transportation. (The U.S. Geological Survey recently concluded that tanker transport in the Arctic has been "found to be technically and economically attractive" while the National Petroleum Council, in its major December 1981 study of U.S. Arctic oil and gas, determined prospective costs for "the wide range of transportation choices available.") In this economic context it is the marketplace, not regulation, that protects consumers and producers from unreasonable pricing or related practices by the TAPS carriers.

This leads to the conclusion that continued regulation of the TAPS carriers' rates is economically unwarranted and without public interest justification, just as is true of oil pipelines in the Lower 48 states. More than that, however, decontrol of oil pipeline rates would remove what has proven to be an administratively burdensome and costly form of regulation that has created unnecessary risks for future pipeline investments. FERC's *Williams Pipe Line Company* decision (issued November 30, 1982) has reduced this administrative burden to some degree. However, the *Williams* decision applies only to pipelines in the Lower 48 states—a distinction not warranted by economic considerations.

Singling out TAPS rates for continued regulation, while freeing existing pipelines in the Lower 48 states for regulatory encumbrances, would send an economically damaging signal to potential developers of oil resources in frontier areas of the ANS and elsewhere. With the prospect that pipelines in such areas would remain regulated, the effect would be to bias investors' evaluations of relative risks versus rewards of developing resources in various geographic locations. Similarly, postponing deregulation of TAPS until the pipeline experiences serious shortfalls of demand would be a poorly conceived strategy. Rather, by eliminating oil pipeline rate regulation promptly, as would be accomplished by passage of H.R. 2677, and relying instead on competitive market forces, productive pipeline investment, vitally important to the development and efficient use of the nation's oil reserves, would be encouraged and thus complement development of our oil reserves.

This concludes my prepared statement. I will be pleased to respond to your questions.

THE TRANSPORTATION OF ALASKAN NORTH SLOPE OIL BY PIPELINE: AN ASSESSMENT OF THE COMPETITIVE ISSUES RELEVANT TO RATE DEREGULATION

Prepared by

Richard J. Barber Associates, Inc.
1828 L Street, N. W.
Washington, D. C. 20036

November 1983

PREFACE

This report, a November 1983 update of our original May 1982 report has been prepared at the request of Amerada Hess Pipeline Corporation, ARCO Pipe Line Company, Exxon Pipeline Company, Mobil Alaska Pipeline Company, Phillips Alaska Pipeline Corporation, Sohio Pipe Line Company, and Union Alaska Pipeline Company. It examines the competitive setting relevant to the transportation of Alaskan North Slope oil, and is intended to provide an economic assessment for use in conjunction with Congressional consideration of measures designed to exempt oil pipelines from rate regulation.

The report has been prepared by Richard J. Barber Associates, Inc., a Washington-based firm that undertakes economic analyses for business and government in matters involving transportation, energy, taxation, antitrust, and other issues pertinent to the regulation of economic activity.

SUMMARY

Because the economies of oil pipelines often require the construction of facilities with large capacity, the number linking a particular area of production with a given destination may be small. In the early days of development of the oil industry this was thought to imply that carriers operating by pipeline might have the ability to price or otherwise act in a monopolistic fashion. This led to the imposition of Federal regulation in 1906, which has persisted to date and is now administered by the Federal Energy Regulatory Commission.

Economic assessment of the facts pertinent to oil pipeline transportation shows that the predicate for regulation does not exist and that pipelines function in a broadly competitive environment. This competition has a number of forms. There may be direct competition among two or more lines, for example but, perhaps most importantly, the oil shipped through a given pipeline -- and even where only one line serves a given field -- confronts competition from domestic and foreign oil transported by other pipelines and by other types of transportation in the markets in which the oil is refined and distributed. Pipeline carriers are thus constrained in the prices they can charge for their services.

As well, oil pipelines have long lives that can extend well beyond the duration of the reserves they are initially built to serve. If those who invest in the construction of the lines are to attract the traffic they require to amortize the cost of construction, they must set rates in the short-run that will encourage long-run exploration and development of oil from areas they can reach. These and other competitive influences lead to the conclusion that oil pipelines in the United States are constrained by market influences and do not possess supposed monopoly power.

What is true generally of competition as it relates to the oil pipelines is also true of the Trans-Alaska Pipeline System (TAPS). Completed in 1977, at a cost of $9 billion, for the purpose of transporting oil from the Alaska North Slope (ANS) to a terminal at Valdez, TAPS is a unified physical entity but involves the operations of eight separate and independent carriers. These carriers establish their own rates (which differ significantly from one another) and transport oil for the various ANS shippers. Some of these shippers are affiliated with the pipeline owners, but others are not. Since the carriers' rates differ, shippers routinely seek out those with the lowest available charges, a fact that means that the carriers ship substantial volumes of oil of unaffiliated users.

Since the ANS crude oil transported by the eight TAPS carriers competes in U. S. end-use markets with an abundance of oil from other domestic and foreign sources (transported by diverse pipelines and transportation modes), its delivered price -- inclusive of the cost of transportation via TAPS -- is constrained by market forces. This is true of Alaska North Slope oil delivered to West Coast refineries (where it competes with oil from California and from foreign countries) and to Gulf Coast refineries (where it competes with oil from Texas, Louisiana, and from various foreign countries, including Mexico). The delivered price of oil from these alternatives sets the price to which ANS oil, moved over TAPS, must conform.

The TAPS pi~~peline~~ commenced operations in 1977 to serve the Prudhoe Bay Unit and has an anticipated life that will extend well into the next century. While the investors plan to amortize its cost over a comparable period, they can do so only if they have an adequate supply of oil to transport. However, output from the Prudhoe Bay Unit itself is expected to begin to decline markedly in the late 1980's, reaching an estimated volume of only 300,000 barrels per day by the year 2000. This latter figure is equal to only a fifth of the current volume transported by the TAPS line. It is thus in the interest of the TAPS carriers, aware of the many years required to develop new oil reserves, to maintain rates in the short-run that will encourage exploration that offers the potential of generating traffic in the 1990's and beyond. These vital long-term considerations also help keep the rates charged by the TAPS carriers at reasonable levels.

The competitive and related factors summarized above (and dealt with at greater length in the accompanying report) obviate the need for continuing regulation of TAPS (as well as other oil pipelines). With decontrol the TAPS carriers will remain constrained in the rates they charge by competition from other oil in destination markets, by their long-term need to encourage the development of oil they can transport through the TAPS line, and by potential competition from Alaskan on-shore or off-shore oil that could be shipped by other (new) pipelines or marine transportation. In this economic context it is the marketplace, not regulation, that protects consumers and producers from unreasonable pricing or related practices of the TAPS carriers.

Continued regulation of oil pipelines, in Alaska as well as the Lower 48 states, is economically unwarranted. More than that, however, decontrol of oil pipeline rates would remove what has proven to be an administratively burdensome and costly form of regulation that has created unnecessary risks for future pipeline investments. By eliminating oil pipeline rate regulation throughout the United States, and relying instead on competitive market forces, these risks would be removed and productive pipeline investment, vitally important to the development and efficient use of the nation's oil reserves, would be encouraged.

I

OIL PIPELINE DEREGULATION: AN ECONOMIC PERSPECTIVE

The pending bill (H.R. 2677) provides for deregulation of rates for the transportation of oil by pipeline common carriers. From an economic perspective the objectives of this bill are sound and consistent with the public interest, manifesting the view that competition can be relied upon as the guiding disciplinary force. The bill would remove from rate regulation all oil pipelines in the United States, including the Trans-Alaska Pipeline System (TAPS) that transports crude oil from the Alaska North Slope (ANS).

From the standpoint of economic logic and fact, as the bill correctly recognizes, the TAPS carriers and the oil pipeline carriers in the Lower 48 states should be treated equivalently. All are subject to competition and all should be treated the same and freed from the needless and counter-productive constraints of existing economic regulation.

Basic Economic Considerations Pertinent to Oil Pipeline Competition and Regulation

Pipelines represent an efficient, safe, and reliable form of transportation for the movement of crude oil and products. They play a vital role in the petroleum industry and, due to the low cost of the service they offer, benefit those who consume any of the many petroleum products.

Because of their sheer physical scale the number of pipelines connecting any two geographic points is not likely to be large. For certain point-to-point markets there may be two or more lines in service, whose ownership may be shared among a number of independent carriers. In some situations, however, there may be only one line serving a given origin and destination (more than one carrier, though, may nonetheless be involved). This has led some to infer that at least some oil pipelines are in a monopolistic position and may be able to price or otherwise behave in an anti-competitive fashion.

Analysis demonstrates, however, that oil pipelines -- even where there may be only one serving a given market -- are subject to a broad range of competitive forces. As is demonstrated in the new study by Edward J. Mitchell[1] (and in the assessments of other economists) an oil pipeline confronts actual or potential competition from other modes of transportation (barge, tanker, truck) as well as from alternative sources of crude supplied from locations which the pipeline cannot serve. As well, the ownership of any given oil line may be shared by two or more carriers which can and do compete with one another in the rates they charge. In addition, geographically dispersed refineries -- served by different crude oil pipelines (and other modes) -- compete with each other in the sale of petroleum products in overlapping consuming markets. All of this means that an oil pipeline carrier is forced to act competitively, for if it seeks to do otherwise, it risks the loss of business and jeopardizes the investment it has made.

In effect, market forces dictate maximum delivered prices paid by consumers; competition also determines the level of oil pipeline rates relative to wellhead values. Since no carrier controls the supply of oil, or is in a position to exclude other transporters serving other available reserves, the rates it charges must reflect the discipline of the marketplace. This is the essence of competition and it means that the TAPS carriers cannot raise the delivered price of ANS crude by increasing their charges. Economic factors likewise constrain their rates vis-a-vis those who ship oil over TAPS since carriers risk a reduction in the exploration required to generate future oil production. New oil production is needed to generate revenue for the carriers after the Prudhoe Bay Unit's output begins to decline and before the TAPS line investment has been amortized.

---

[1] A Study of Oil Pipeline Competition (April 1982).

Related to this -- and giving accentuated emphasis to the role of competition -- is the long-lived character of oil pipeline investments. When put in service -- at immense cost -- a pipeline typically has a physical life of 30 years or more. The investment commitment is also extended over time, so that amortization calls for use of the pipeline for a number of decades. With respect to a new line in a pioneer area -- such as TAPS -- the life of the economically recoverable petroleum reserves it serves at the outset will be exhausted, substantially depleted, or certainly declining well before the end of the line's life (and related period of amortization). For the carriers owning a line, therefore, rates must be set not only at levels in the short-run that reflect competitive conditions but in a manner that encourages the long-term development of new oil production. This adds still another constraint on the pricing of oil pipeline transportation.

Basic Competitive Forces Govern the Eight TAPS Carriers

Oil pipelines, as is widely recognized among those familiar with the situation, function within the multi-dimensional competitive environment summarized above. In the shipment of crude the carrier involved (sometimes owning an undivided interest in a single physical line) competes in its pricing and marketing efforts to attract volume. Thus, if two carriers each have 50 per cent undivided ownership interests in a pipeline and neither has sufficient volumes tendered by shippers to utilize half of the line's capacity, then each must attract additional petroleum from other shippers. Pipeline carriers also compete with other modes and indirectly with sources of supply they do not serve. In the delivery of oil to refineries they meet still other competition -- from other crude sources; from other refineries, with access to other oil, that serve common areas of product distribution; and from other modes (and in some instances other pipelines) serving alternative production sources. It is this competition which H.R. 2677 correctly recognizes as a basis for decontrol of oil pipelines.

Competition is clearly present in the transportation of ANS oil via TAPS. Without dealing here with the key points at length (more detailed discussion will follow), it will nonetheless be useful to highlight five of the competitive features pertinent to the oil transported from the North Slope by the TAPS carriers.

(1) To correct a common misimpression, TAPS is not a single monolithic entity. Rather, TAPS is a jointly owned (and efficient) physical facility which is used by eight separate common

carriers. These carriers set their own rates independently and in accordance with their own economic assessments. Significantly, their rates differ and have differed from the time the owners filed their first tariffs in 1977.

(2) While ANS oil moved by the eight carriers through the TAPS line is presently substantial in volume, it is not unique, and in the destination U. S. markets in which it must be used it competes with oil from other American and diverse foreign sources. Since ANS crude must compete with substitutable oil at the refinery, it is the delivered price and availability of other oil that set the final price at which ANS oil can be sold. This is potent competition and with worldwide petroleum supply rising (and demand falling), declining global oil prices directly affect all those concerned with the production and transportation of ANS oil, including the TAPS carriers.

(3) The eight carriers that share use of the TAPS line are not identically postured. Some have relatively large shares of the line's capacity, others much smaller shares (four have percentages of less than five per cent each, with the other four having separate interests ranging upwards from 16.67 per cent). While the affiliates of some carriers produce enough Prudhoe Bay Unit oil to make full use of the carriers' shares of pipeline capacity, in other cases affiliates of pipeline owners do not produce sufficient crude to fill the carriers' ownership shares. Independents as well as affiliates of pipeline owners tender

their oil first to carriers who offer more favorable rates, with the result that each carrier often transports more oil of unaffiliated producers than of its own affiliate.

Over time, and as Prudhoe Bay Unit production declines (expected to begin in the late 1980's), the prospect is that the imbalance between carriers' shares of line capacity and the pipeline affiliates' petroleum production will change considerably, with an accentuation of competition for traffic as all carriers seek to fill their capacity shares.

(4) Not all those with Prudhoe Bay oil production are affiliated with a TAPS carrier. The state of Alaska itself has a one-eighth interest in crude production, for example, and some ten private firms (with smaller production) are similarly situated. All shippers are concerned with obtaining the best price they can get for the transportation of their oil. Over time it is probable that even more new firms will commence ANS production and thus fall into this category, with consequent competitive ramifications.

(5) In pricing their services in the short-run the eight TAPS carriers must take account of their need for traffic in future years, well after production from the Prudhoe Bay Unit has commenced to decline. Since the pipeline rates affect the wellhead yield available prospectively to potential producers, they influence the incentive to explore on the ANS as compared with other geographic areas. Charging excessive rates in the short-

run would discourage such exploration activity and risk serious financial harm to the carriers, given their commitments (which extend well into the next century). These factors will constrain each carrier's pricing even without regulation.

In composite these interrelated considerations define a dynamic and vigorous competitive environment for the TAPS carriers. Accordingly there is no reason why the eight carriers who share use of the TAPS line should be subject to continuing regulation.

There Is No Need for Oil Pipeline Regulation or Public Interest Justification for Its Perpetuation

Given the applicable economic facts it is apparent that competition -- in all its diverse forms -- disciplines the pricing of the TAPS carriers. Continued regulation is thus unnecessary. More than that, it is detrimental to the national interest in the development of American oil resources, which will continue to require large additional investment in pipeline construction and expansion (as well as in other physical facilities). Recent experience has shown that regulation is not just costly and burdensome but creates a thick cloud of uncertainty that threatens to discourage pipeline investment. This has serious long-run deleterious implications for this country's energy strategy.

From the standpoint of the public interest, since competition sets the boundaries for the pricing of petroleum, regulation to protect the consumer is needless and, indeed, negative in its effects. Further, independent producers and producers affiliated with pipeline owners, suffer alike from the market distortions inherent in the application of price controls. Potential producers seek to establish the true long-run economic costs -- including transportation -- of Alaska crude sources vis-a-vis other locations of crude oil before committing capital. Regulation, by denying the opportunity for competitive forces to establish pipeline rates, can inhibit desirable investment. In the case of TAPS, while one party -- the state of Alaska -- might profit in the short-run (at the expense of those who built the line) from artificially contrived rates generated by regulation, the American public generally would not benefit, for it is competition, not regulation, that is the determining factor in assuring efficient use of economic resources. This clearly calls for an end to oil pipeline regulation, in Alaska no less than in the Lower 48 states. The ensuing assessment provides more detailed elaboration of the considerations warranting this conclusion.

II

ALASKA NORTH SLOPE OIL TRANSPORTED BY THE EIGHT TAPS CARRIERS COMPETES WITH OTHER SOURCES OF CRUDE

Alaska North Slope oil is but one among many sources of supply for the U. S. market. Refineries that can use ANS crude also can employ crude from foreign as well as Lower 48 production. Indeed there is now an abundance of supply, in part reflecting a slowing of demand for petroleum products in the face of increased reserves of oil around the world. This competition sets the effective delivered price of ANS oil and the eight TAPS carriers -- as well as all who produce oil in Alaska -- are compelled to adapt to this competitively determined petroleum price. In the final analysis it is competition, not regulation, which will constrain the pricing of the services offered by the eight TAPS carriers and of the ANS crude which they transport.

U. S. Markets in Which ANS Oil is Distributed

Under existing law all of the ANS oil must be used in the United States and its territories. Under prevailing conditions the most obvious area in which it can be distributed is along the West Coast, to which shipments are made from Valdez in large tankers. However, market conditions -- including other available and competing sources of supply -- have been such that not all of the ANS crude can be sold along the West Coast. (In fact in December 1982 Alaskan crude accounted for only about one-third of that received at West Coast [PAD V] refineries.[1]) A sizable share thus must be distributed elsewhere in the Lower 48 states. Since the only major pipeline capable of transporting crude from the West Coast eastward has a capacity of only 60,000 barrels per day (bpd), most of the ANS crude not marketed in this area has been moved by water through Panama into the Gulf of Mexico. Because this involves transloading to the trans-Panama pipeline or use of smaller U. S. flag vessels that can transit the Canal, the cost of water transportation is relatively high (about $5 per barrel).

The volume of ANS crude shipped to destinations east of the Rockies varies considerably, depending on the balance of supply and demand on the West Coast. At times, however, as much as a half (and sometimes more) is shipped to the Gulf. Panama Canal Commission statistics show that the ANS volume moving via the Canal has been increasing, rising from 114 million barrels in its Fiscal Year 1979 to 232 million barrels in its FY 1982.

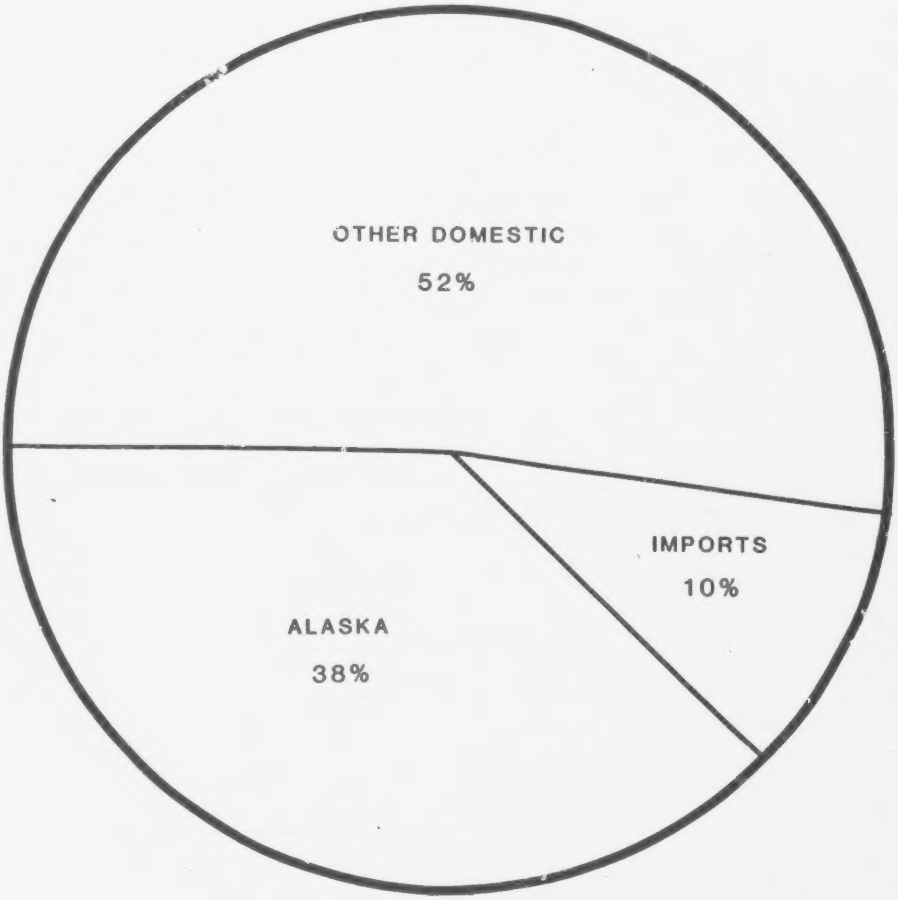
At any given time the share of the ANS oil moved east of the Rockies depends on a number of factors, including West Coast demand, the volume of foreign imports, the amount of oil from other domestic sources, and, of course, the comparative delivered prices of alternative foreign and domestic supplies. The interaction of these factors sets the market terms which govern the sale of crude produced on the ANS and transported by the TAPS carriers.

---

[1] Petroleum Administration for Defense (PAD) V consists of Washington, Oregon, Arizona, Nevada, California, Hawaii, and Alaska.

Figure 1

SHARES OF REFINERY RECEIPTS OF CRUDE OIL,
BY SOURCE, PAD V (WEST COAST), 1982



Source: DOE, Refinery Receipts Report.

In the Lower 48 Markets Where ANS Crude Is Distributed It Faces Intense Competition from Other Sources of Supply

In each of the two principal areas of the U. S. in which ANS oil is distributed -- along the West Coast and the Gulf of Mexico -- substantial volumes of oil from other sources are available for refinery use. This is not potential competition -- it is real day-in, day-out competition from suppliers with an abundance of crude at their disposal. Data published by the Department of Energy demonstrate this, as the following summaries will indicate.

West Coast. During 1982 West Coast refineries (categorized in PAD V) received 756.5 million barrels of crude oil.[1] Alaska provided some 38 per cent of this total, with the remainder coming from foreign and other (Lower 48) sources (see Figure 1).

All told, foreign imports entering PAD V during 1982 accounted for refinery receipts of 68.7 million barrels of crude oil. Indonesia accounted for the bulk of the crude imported into PAD V, but significant volumes of crude were also obtained from such countries as Algeria, Ecuador, Brunei, Canada and Malaysia.[2]

In terms of competing domestic supplies of oil for PAD V refineries, California, as might be expected, is dominant. During 1982 wells in California produced more than 401.6 million barrels of oil.[3] Contrary to experience in other Lower 48 producing areas, California oil output has been rising (including the production of light oil) and is expected to increase at least one to two per cent annually during the next few years.[1] Since California oil is situated closer to the state's large refineries -- delivered by pipeline and in some cases by truck -- it presents formidable competition for oil from Alaska (although it, too, must compete against imports).

---

[1] DOE, Refinery Receipts Report (1982) [hereinafter Refinery Receipts Report].

[2] DOE, Petroleum Supply Annual, 1982 at 49-50.

[3] DOE, Petroleum Supply Annual, 1982 at 37.

Looking to the future, it is expected that "the U. S. West Coast will be awash with crude through the rest of the century."[2] As a result shipments of crude from the ANS to the Gulf of Mexico are projected to double by 1985. Since California crude has a locational advantage on the West Coast, ANS crude will remain an incremental source of supply in a market in which product demand has fallen (and is unlikely to expand) and in which imports pose a continuing supply alternative. These factors signal increasing competition for sellers of North Slope oil.

Gulf of Mexico. As noted earlier, some of the ANS oil -- at times as much as a third -- cannot be sold on the West Coast and moves east of the Rockies for distribution. There it competes with literally a flood of other domestic and foreign oils. In 1982 refineries located in PAD III (a defined region that includes Texas, Louisiana, Alabama, Mississippi, Arkansas, and New Mexico) reported receipts of 1.9 billion

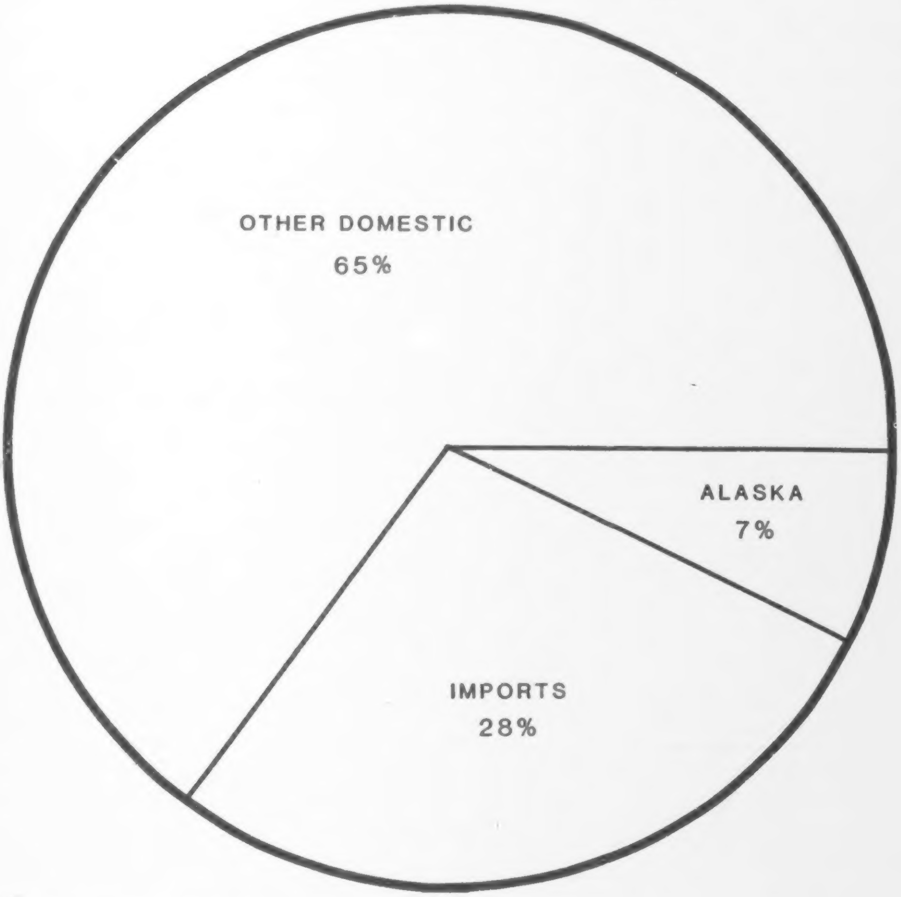
---

[1] Oil and Gas Journal (December 7, 1981) at 73 and (April 5, 1982) at 127. This rate may be understated in view of the recent Santa Maria discoveries.

[2] Id. (April 12, 1982) at 51.

Figure 2

SHARES OF REFINERY RECEIPTS OF CRUDE OIL, BY SOURCE, PAD III (GULF), 1982



Source: DOE, Refinery Receipts Report.

barrels of crude oil.[1] About 28 per cent came from imports, the remainder from domestic sources[2] (see Figure 2).

The crude imported into PAD III during 1982 (of which some but not all was used at refineries in that area) came from a large number of both OPEC and non-OPEC countries. Mexico, with vast new deposits of oil discovered in recent years and now the world's fourth biggest producer, has become a chief supplier and a competitive source of great potential consequence. In December 1982, for example, Mexico exported some 14.8 million barrels to PAD III, almost as much as the 16.6 million barrels received from all OPEC countries combined.[3] Other major suppliers included Saudi Arabia, the United Kingdom (North Sea), Norway (North Sea), Nigeria, Venezuela, and Trinidad.

Price Competition. Given the plentiful supply of crude oil in the Lower 48 areas in which ANS oil is marketed, namely on the West Coast and east of the Rockies, price competition is intense. In fact, as is now widely known, the price of oil has declined markedly during 1981 and 1982. Just between February 1981 and July 1983 the refiner-acquisition cost of crude oil dropped by nearly twenty-one per cent for oil from domestic sources and by about twenty-six per cent for imported supplies.[4] Since the beginning of 1983 prices have fallen still more, to levels below the $30 plus target prices which OPEC has sought to achieve. Prices for imported crude oil fell below the $28 benchmark in April 1983.[1]

---

[1] Texas Gulf and Louisiana refineries accounted for 87 per cent of PAD III crude receipts.

[2] Refinery Receipts Report.

[3] DOE, Petroleum Supply Monthly (February 1983) at 63.

[4] DOE, Monthly Energy Review (October 1983) [hereinafter Monthly Energy Review] at 82.

Recent Changes in Worldwide Oil Demand and Supply Have Intensified the Competition Confronting ANS Crude

Recent trends in the demand for and the supply of oil, worldwide, will increase competition further in the sale of crude. This bears directly on ANS oil and those who produce and transport it, for this competition sets the final delivered price at which ANS oil can be sold in the United States.

The demand for oil has slowed considerably since 1979 while its supply (as measured in reserves) has increased substantially. Petroleum consumption in the member countries of the International Energy Agency (IEA), which include the principal industrialized nations, fell by nearly 17 per cent between 1979 and 1982.[2] This has been mirrored in the U. S. as well, whose petroleum use has fallen each year since 1978 (our petroleum demand declined 19 per cent from 1978 through 1982).[3] Those depressed levels of demand are continuing. In the week ended October 21, 1983, for example, total U. S. demand for petroleum products was below that of the same week a year earlier, despite recovery from the recession.[4]

---

[1] _Ibid._

[2] _Id._ at 98.

[3] _Ibid._

[4] _Oil & Gas Journal_, OGJ Newsletter at 2.

Meanwhile, however, worldwide oil reserves have grown substantially, up by about 24 billion barrels between January 1978 and January 1983, while U. S. oil reserves remained essentially unchanged.[1] To cite one major illustration, Mexico, a large supplier at present to the U. S. and potentially of much greater consequence, reported oil reserves in 1979 of 31 billion barrels which increased to an estimated 48 billion barrels in 1982.[2] In 1982 it announced plans to export 1.5 million barrels daily (about equal to current ANS production) and made a seven per cent reduction in the price of its better-grade oil.[3]

The twin forces of a slowing in oil demand and an increase in reserves have brought about noticeable downward pressure on oil prices, as noted earlier. This has resulted in a reduction in crude oil production, with 1982 world crude oil output down 10.7 per cent from 1980.

These important developments are not passing phenomena. An oversupply of oil is expected to persist for years, due to recent and anticipated discoveries juxtaposed against a rate of growth in demand that is likely to fall below the pace of economic expansion. This will intensify competition among sources of supply, with the prospect that the world oil price will increase only slowly in coming years (one study forecasts real average annual price increases for oil of but 2.5 per cent from now through the end of this century as compared with increases averaging 29 per cent a year since 1973).[1]

---

[1] American Petroleum Institute, Basic Petroleum Data Book (May 1983) at II-1a.

[2] Oil & Gas Journal (December 27, 1982) at 79 and (December 31, 1979) at 71.

[3] New York Times (March 31, 1982) at D7.

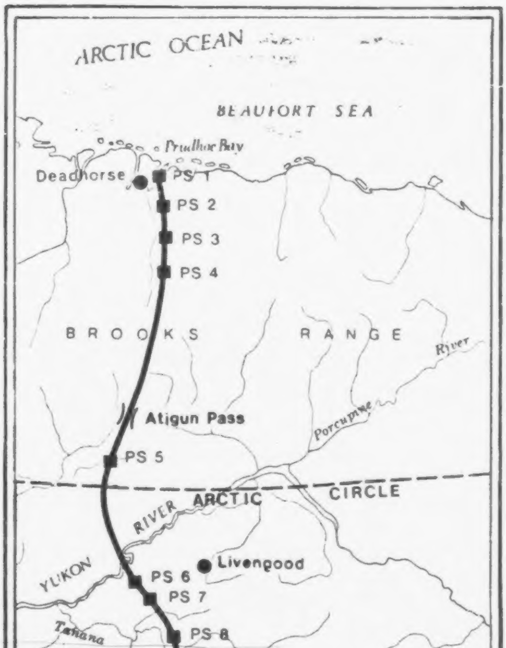
All of these extant and emerging market forces bear heavily on those firms involved with ANS oil. While the Alaskan oil reserves are substantial, so too are the reserves of oil in other countries as well as in the United States itself (apart from Alaska). If the North Slope oil is to be sold in the quantities that will keep each TAPS carrier's share full, it is evident that ANS oil will have to meet a market price (i.e., at the refinery gate) that will be determined by bountiful alternative sources of supply and by a constrained level of demand. The eight TAPS carriers, no less than the producers of ANS oil, must be aware of these competitive forces. They are compelled by the laws of economics to respond to the short-run dictates of the market while considering longer-term consequences. Given the competitively determined world selling price of crude, any increase in TAPS rates would serve only to lower wellhead prices of ANS crude and consequently discourage development of new ANS sources on which the carriers depend. Thus, the balance between pipeline rates and wellhead prices is also subject to competitive market forces, as described in Part III.

---

[1] Chase Manhattan Bank, The World Energy Outlook Through 2000: A Time Of Transition (1981).

Figure 3

MAP OF THE TAPS ROUTE


ARCTIC OCEAN
BEAUFORT SEA
Prudhoe Bay
Deadhorse
PS 1
PS 2
PS 3
PS 4
BROOKS RANGE
River
Atigun Pass
Porcupine
PS 5
ARCTIC CIRCLE
YUKON RIVER
Livengood
PS 6
PS 7
Tanana
PS 8
PS 9
PS 10
River
River
Susitna
PS 11
PS 12
Valdez
Terminal
Cook Inlet
GULF OF ALASKA
PS = Pump station
(Existing & Planned)
0 mi
100
200
0 km
100
200
300

Source: U. S. Geological Survey.

III

COMPETITION IN THE TRANSPORTATION OF ALASKA NORTH SLOPE OIL

Currently something in excess of 1.6 million barrels of oil are transported on an average day from the Alaska North Slope to Valdez. All of this oil is transported through the TAPS pipeline, a fact that has led some observers to the superficial conclusion that the line is a de facto monopoly and will remain such in the future. In economic reality, however, there are eight independent and differentially postured carriers who operate through TAPS. As the present Prudhoe Bay Unit reserves begin to decline (starting in the late 1980's) competition among the carriers will intensify as they seek to maintain throughput and thereby generate the revenue needed to amortize investments that extend well into the next century. These and related factors depict, not supposed monopoly, but competition, as the ensuing discussion will demonstrate.

TAPS -- Its Physical and Functional Attributes

In physical terms TAPS consists of a 48-inch pipeline stretching approximately 800 miles from Prudhoe Bay (technically the Prudhoe Bay Unit) in the north to Valdez in the south and associated terminal facilities and pumping stations (see Figure 3). Its history traces to a 1969 decision to construct a pipeline facility with daily capacity of 600,000 barrels, but the final details -- including an election to increase capacity to 1.2 million barrels per day (bpd) -- were arrived at in 1974. Construction began that year and the line started service in the summer of 1977. Built at a cost of about $9 billion, it represents the largest private investment undertaking in history and one of the most formidable engineering ventures ever initiated.

In functional terms the TAPS line was designed for the immediate purpose of transporting ANS oil from the Prudhoe Bay on-shore reserves for eventual use in the United States. Although the Prudhoe Bay reserves are sizable, and annual average daily output is limited by the state of Alaska to 1.5 million barrels, it has been known since the outset that production will begin to decline in the late 1980's. By one estimate Prudhoe Bay output may be as low as 300,000 bpd by the year 2000.[1] The TAPS line, by contrast, has a physical life that will extend to and probably beyond the year 2012. While the line is presently being fully used, therefore, over the long-run production from other reserves will be required in order to exploit its large capacity.

When opened in 1977 the TAPS line had a mechanical capacity of 1.2 million bpd. Since then its mechanical capacity has been increased to 1.42 million bpd through additional investment and engineering modifications and, through operational improvements, TAPS recently has handled in excess of 1.6 million bpd. With construction of additional pumping stations, TAPS could, if economically justified, carry 2 million bpd.

Every barrel of ANS oil now being produced (including a comparatively small amount from new production in the Kuparuk River field west

---

[1] Report of the Comptroller General to the Congress (EMD-81-11, January 6, 1981) [hereinafter Comptroller General Report (EMD-81-11)] at Appendix I, p. 58.

Figure 4

EIGHT CARRIERS OPERATE VIA THE TAPS PIPELINE

Carrier	Interest (%)	Share of Daily Throughput (In barrels)*
Sohio Pipe Line Co.	33.3363	533,380
ARCO Pipe Line Co.	21.3547	341,675
Exxon Pipeline Co.	20.3378	325,405
BP Pipelines Inc.	16.6745	266,792
Mobil Alaska Pipeline Co.	04.0845	65,352
Phillips Alaska Pipeline Corp.	01.3561	21,698
Amerada Hess Pipeline Corp.	01.5000	24,000
Union Alaska Pipeline Co.	01.3561	21,698

---

* Expressed as share of approximate daily throughput of 1,600,000 barrels.

of Prudhoe Bay)[1] is being handled by the TAPS carriers. While some allege, without supporting facts, that pipeline owners seek to underdesign pipelines to restrict supply, it is clearly in the economic interests of pipeline firms to construct lines with sufficient capacity to carry all of the crude oil that is tendered. It is no less in the interest of a producer investing in a pipeline to seek sufficient capacity to move its product to market. Similarly, once a pipeline is in place, pipeline owners will seek to maximize throughput as a matter of economic necessity, given the need to amortize their investments. Thus, the experience of the TAPS carriers is consistent with rational competitive behavior, not with vague allegations of monopolization.

What we have in TAPS, therefore, is a highly efficient means of transporting ANS oil for the U. S. market (Prudhoe Bay crude moves over the 800 miles at a cost of about 3/4 of a cent per barrel mile) but as well a costly, long-lived asset whose continued financial viability depends both on the delivered price of ANS oil (relative to prices of other alternative supplies) and on the development of major new reserves. This, as noted later, bears directly on the rates charged by the TAPS carriers, for the rates, in turn, influence exploration on the ANS.

Eight Separate Carriers Operate Via TAPS with Varying Affiliated ANS Oil Production

As previously stated, TAPS is not the name of a common carrier oil pipeline but simply designates a physical pipeline system owned in

---

[1] Production at Kuparuk began in December 1981 and ran at a daily rate of about 89,000 barrels during 1982. This oil moves to TAPS over a new 27-mile connecting line.

Figure 5

THE EIGHT TAPS CARRIERS POSTED SEPARATE TARIFFS FOR THEIR TRANSPORTATION OF ANS OIL WHEN THEY COMMENCED OPERATIONS

Carrier	Effective Date of Tariff	Rate/barrel
Amerada Hess Pipeline Corp.	7/1/77	$6.44
ARCO Pipe Line Co.	6/30/77	6.04
BP Pipelines Inc.	6/30/77	6.35
Exxon Pipeline Co.	6/30/77	6.27
Mobil Alaska Pipeline Co.	6/30/77	6.31
Phillips Alaska Pipeline Corp.	7/20/77	6.22
Sohio Pipe Line Co.	7/30/77	6.16
Union Alaska Pipeline Co.	6/30/77	6.09

Source: Tariffs as initially filed with I.C.C.

undivided interests by eight separate common carrier companies, each of which has the exclusive right to use a specified portion of the capacity of the pipeline facility for its independent business (see Figure 4). The situation is basically no different than if the eight carriers had each built a physically distinct line except that if they had done so shippers and the public would have lost the economies of scale stemming from construction of a single 48-inch line.

Each carrier has its own financial commitment to protect and is thus responsible for pricing and marketing the capacity to which it is entitled and realizing the revenue derived from its traffic volume. Reflecting this, and indicative of their independence, the eight carriers have established and maintained since the outset of TAPS operation different rates. The separate tariffs they filed in the summer of 1977 (see Figure 5) differed from one another by significant margins, ranging from $6.04 per barrel to $6.44 per barrel (a range of over six per cent). In addition, downward adjustments to $5.30 and $5.40 per barrel, effective during the 1982-1983 period, were made by Exxon and BP.

Significant also from a competitive standpoint is that the eight carriers are not like-postured in affiliates' shares of Prudhoe Bay oil production, with account taken of the state of Alaska's royalty (in kind) interest. As can be seen in Figure 6, most of the carriers' affiliates have production in the Prudhoe Bay Unit less than the carriers' shares of the line's capacity (ARCO Pipe Line, for instance, has 21.3547 per cent of the line but Atlantic Richfield has only 18.954 per cent of production from the Unit). Two producers, Sohio and Phillips, are in the opposite

Figure 6

THE EIGHT CARRIERS' SHARES OF TAPS CAPACITY DIFFER FROM THEIR AFFILIATES' AND OTHER SHIPPERS' PERCENTAGES OF PRUDHOE BAY UNIT OIL PRODUCTION

Entity	Interest in Oil Production		Carrier TAPS Interest		Surplus (Shortage) of Oil Compared With TAPS Interest (Barrels/Day**)
	Per Cent	Barrels/Day*	Per Cent	Barrels/Day*	
Standard Oil (Ohio)	44.106	661,590	33.3363	500,045	161,545
Atlantic Richfield	18.954	284,310	21.3547	320,321	(36,011)
Exxon	18.952	284,280	20.3378	305,067	(20,787)
State of Alaska	12.500	187,500	--	--	187,500
Mobil Oil	1.845	27,675	4.0845	61,268	(33,593)
Phillips Petroleum	1.802	27,030	1.3561	20,342	6,688
Amerada Hess	.471	7,065	1.5000	22,500	(15,435)
British Petroleum	.001	15	16.6745	250,118	(250,103)
Union Oil of Calif.	--	--	1.3561	20,342	(20,342)
Other Producers	1.370	20,500	--	--	20,550

* Expressed as share of 1,500,000 barrels of daily oil output from the Prudhoe Bay Unit assuming the state of Alaska takes its share in kind; does not include interests in North Slope fields other than Prudehoe Bay.

** Positive figure denotes net buyer of pipeline service, negative figure denotes net seller of pipeline service.

position, with more oil production than their respective affiliated carriers' shares of line capacity. Not one of the carriers has affiliated oil production equal to its share of pipeline capacity. All are thus net buyers or sellers of pipeline capacity. Moreover, because the tariff rates differ among the carriers, shippers seek out the best available price from among the options available, even if this means using an unaffiliated carrier. The result is that TAPS carriers with the lower prevailing rates are compelled to prorate their capacity among shippers, with the consequence that they typically do not move all the oil of their producing affiliates through their lines.

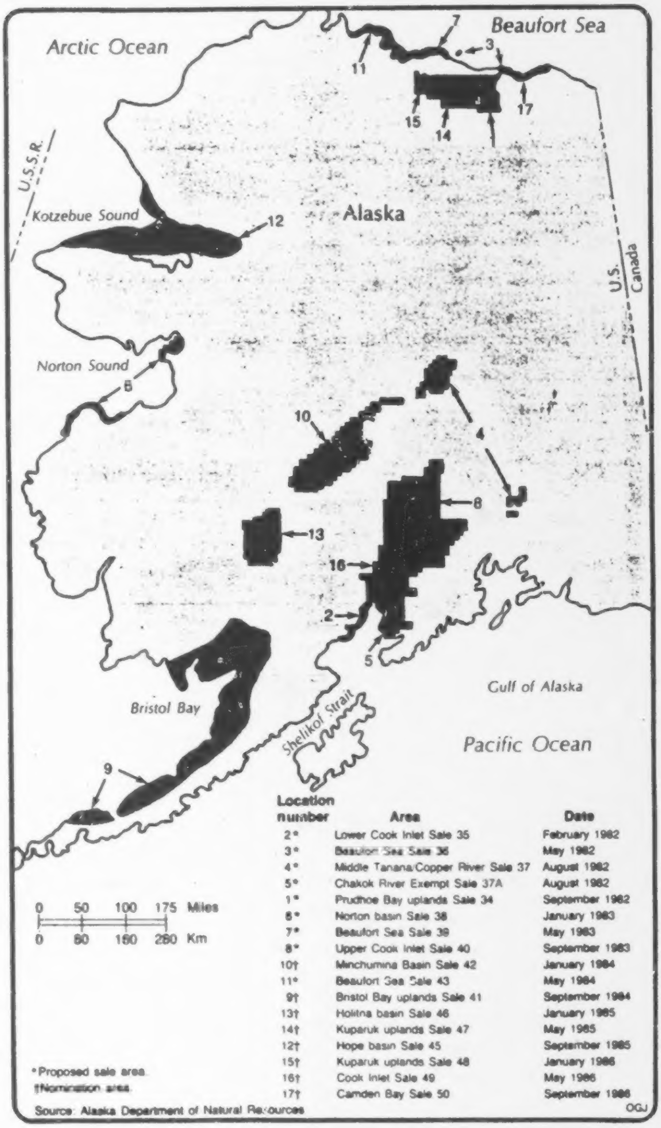
As production of oil from the Prudhoe Bay Unit declines the prospect is that the shipment of oil through TAPS will change in terms of its ownership and in its balance of demand and supply as among the carriers. Absent new production each carrier's capacity is likely to exceed the available traffic. However, even if new supplies are developed, the shares and identities of the producers may differ from the present situation. The state of Alaska's five-year leasing program (see Figure 7) demonstrates that new oil-potential areas to be developed are often far distant from the Prudhoe Bay Unit which is served by TAPS. Similarly, Federal leasing is proceeding at diverse sites.[1] As exploration proceeds, it will probably result in a growing disparity between each carrier's share of TAPS capacity and its affiliate's production. The

---

[1] The U. S. Government also intends to award leases on its Alaskan lands, which often are considerably removed from the Prudhoe Bay Unit. These leases are expected to be awarded in 1982-85. Oil & Gas Journal (January 18, 1982) at 53.

Figure 7

THE STATE OF ALASKA'S PROPOSED FIVE YEAR LEASING PROGRAM ANTICIPATES EXPLORATION IN GEOGRAPHICALLY DISPARATE REGIONS


Arctic Ocean
Beaufort Sea
7
3
11
15
14
17
U.S.S.R.
Kotzebue Sound
12
Alaska
U.S.
Canada
Norton Sound
6
10
4
8
13
16
2
5
Gulf of Alaska
Bristol Bay
Shelikof Strait
Pacific Ocean
9
0 50 100 175 Miles
0 80 160 280 Km

Location number	Area	Date
2*	Lower Cook Inlet Sale 35	February 1982
3*	Beaufort Sea Sale 36	May 1982
4*	Middle Tanana/Copper River Sale 37	August 1982
5*	Chakok River Exempt Sale 37A	August 1982
1*	Prudhoe Bay uplands Sale 34	September 1982
6*	Norton basin Sale 38	January 1983
7*	Beaufort Sea Sale 39	May 1983
8*	Upper Cook Inlet Sale 40	September 1983
10†	Minchumina Basin Sale 42	January 1984
11*	Beaufort Sea Sale 43	May 1984
9†	Bristol Bay uplands Sale 41	September 1984
13†	Holitna basin Sale 46	January 1985
14†	Kuparuk uplands Sale 47	May 1985
12†	Hope basin Sale 45	September 1985
15†	Kuparuk uplands Sale 48	January 1986
16†	Cook Inlet Sale 49	May 1986
17†	Camden Bay Sale 50	September 1986

*Proposed sale area.
†Nomination area.

Source: Alaska Department of Natural Resources

OGJ

Source: Oil & Gas Journal (April 5, 1982).

range of buyer-seller competition will be increasingly broadened, since carriers will have additional surpluses or shortages of line capacity depending on the extent to which their producing affiliates draw down Prudhoe Bay Unit reserves and develop alternative ANS sources.

The Competitive Role of Independent Shippers of ANS Oil Who Have No Ownership Interest in the TAPS Line

There are a number of shippers who have no ownership interest in the line. Their primary concern is to obtain transportation on the best available terms from one or more of the carriers.

Chief among these independent shippers is the state of Alaska itself. It has a 12.5 per cent royalty interest in Prudhoe Bay production and to the extent that Alaska takes its share in kind -- perhaps selling a portion of its oil to others -- transportation is required.[1] Apart from the state of Alaska there are other Prudhoe Bay producers who have no ownership participation in the TAPS facility. Although their individual throughput is not large, it still aggregates approximately 7.5 million barrels per year. In combination the state and the independent producers have the ability to produce about 75 million barrels of oil from Prudhoe Bay each year (assuming the state takes all of its royalty share in kind). Using a weighted (by share of capacity) average of the tariffs posted in 1977 as a guide, or $6.20 per barrel, this traffic can yield roughly $465 million annually in revenue to the carrier or carriers who furnish the pipeline transportation (and who bear the continuing

---

[1] The state of Alaska has announced that it intends to take in kind and to sell approximately seven-eighths of its royalty oil. Oil & Gas Journal (March 15, 1982) at 46.

Figure 8

MANY OF THE COMPANIES EXPLORING FOR OIL ON THE ALASKA NORTH SLOPE HAVE NO OWNERSHIP INTEREST IN THE TAPS PIPELINE

Companies (Including Affiliates) With Ownership Interest in TAPS	Companies Without Ownership Interest in TAPS
Amerada Hess	Amoco (Standard Oil Of Ind.)
Arco	Ashland
British Petroleum	Champlin
Exxon	Chevron (Standard Oil of Calif.)
Mobil	Conoco
Phillips	Getty
Sohio	Gulf
Union	Louisiana Land and Exploration
	Marathon
	Murphy
	Placid
	Shell
	Tenneco
	Texaco

Sources: Alaska Oil & Gas Conservation Commission;
Oil & Gas Journal.

burden of its construction cost and operation). This is clearly of consequence for any of the carriers, especially as declining ANS production looms on the horizon.

With the anticipated decline of Prudhoe Bay Unit production that is expected to take place beginning in the late 1980's, the role of producers without any ownership stake in TAPS is almost certain to expand. Exploration now underway and expected along the ANS (and in adjacent off-shore areas) portends the involvement of new oil owners (see Figure 8) which have no existing ownership interest in TAPS and which in many cases are not currently among those producing oil in the Prudhoe Bay Unit. If and when they develop oil for production, their concern will be to arrange transportation (by one of the eight TAPS carriers or by some potential new means of transportation) at the lowest available cost. Too, as companies now producing oil at Prudhoe Bay explore in other ANS areas (off-shore or to the west or east of the Unit), the relative shares of oil they will ship are likely to change. As all of these factors evolve the eight carriers will be forced to compete as they struggle to obtain traffic to fill their shares of TAPS capacity.

In setting rates under deregulation, the carriers thus must price in a manner that protects their long-run interests. Carriers must encompass long-run considerations in their rates, recognizing that an excessive current rate could chill exploration on the part of those who might in future years provide a sizable share of throughput. Moreover, excess rates would encourage the construction and development of competing transportation alternates. Since the carriers cannot now know who will be producing oil in coming years (and since those interested in exploring for oil have a wide range of options, including other parts of the United States as well as in other countries), it is in each carrier's economic interest to establish rates that encourage developmental activity on the North Slope. This essential long-term view bears heavily on the present ratemaking environment and instills a form of competition that will contribute to the maintenance of reasonable rates via TAPS even without regulation.

Since Prudhoe Bay Production Will Decline Well Before the Carriers Have Amortized Their Investments, Competition Is Intensified

Pipelines like TAPS involve not just immense initial cost but have a lengthy lifespan -- one that generally exceeds the life of petroleum reserves that the lines are originally installed to serve. In setting rates in the short-run the carriers owning shares of the line must do so with an eye to the future, for today's tariffs influence long-run traffic prospects.[1]

In the case of TAPS the stipulated service life of the facility is approximately 35 years from its opening for service.[2] This puts the end of its life in the year 2012, long after production from the Prudhoe Bay Unit will begin to decline. Indeed one estimate is that the decline will commence after 1985-1986, with production to fall to 300,000 barrels per day by the year 2000 and to as low as 85,000 bpd by 2005.[1] Since the line is presently carrying over 1.6 million bpd it is obvious that without the development of new production on the ANS the line would be seriously under-used.

---

[1] At least in the Arctic, exploratory drilling alone requires about four years, with development drilling peaking six years from the commencement of exploration. National Petroleum Council, U. S. Arctic Oil & Gas (December 1981) [hereinafter U. S. Arctic Oil & Gas] Chapter 3.

[2] Parties to FERC Docket No. OR-78-1 have stipulated and agreed to a 30-year service life from January 1, 1982 (stipulation dated February 11, 1982).

While the supply outlook contains sizable risks, the financial implications of a shortfall in TAPS throughput are of pronounced severity. To be borne in mind is that each carrier which owns an interest in TAPS has committed itself to financial terms that extend beyond the twentieth century. While the exact terms vary from carrier to carrier, those of Exxon Pipeline Company are illustrative. To finance its share of the cost of constructing TAPS, Exxon Pipeline Company issued debentures during the mid-1970's with maturities of 25 to 30 years (exact years of maturity range from 2000 to 2004). These debt instruments require, apart from semi-annual interest payments, annual sinking fund payments until maturity of $32.5 million (depending on the year and the detailed governing provisions). Thus involved are obligations stretching well beyond the time when Prudhoe Bay Unit output will be falling.

Given these conditions, it is in the indisputable economic interest of each of the carriers to set rates, now, that will encourage exploration by affiliates and independents alike which could result in new production of oil that would move (and from which carriers could obtain revenue) in coming years. Even though there is excellent potential for new oil production on the ANS, the exploration required takes years and the costs are extremely high (present costs of drilling a well range from $20 million to $40 million at off-shore sites in the Beaufort Sea).[1] A potential producer of ANS oil takes these exploration costs into account, together with other relevant costs including the prospective rates for pipeline transportation via TAPS, in order to project the net wellhead yield. If it is too low, in absolute terms or relative to anticipated yields in other geographic areas available for exploration, the potential producer can shift his emphasis accordingly (either foregoing exploration on the North Slope or reducing ANS commitments). The TAPS carriers are well aware of this and hence must set rates in the short-run that will encourage rather than discourage exploration on the ANS that could assure them of the volume needed in the future to amortize their long-lived investments. This is a key economic factor, one that constrains the pricing of transportation by the carriers over the TAPS line.

---

[1] Comptroller General Report (EMD-81-11) at Appendix I, p. 58. The National Petroleum Council anticipates that current production levels from the Prudhoe Bay Unit will continue "through 1987." U. S. Arctic Oil & Gas at 47.

Potential Transport Competition for ANS Oil

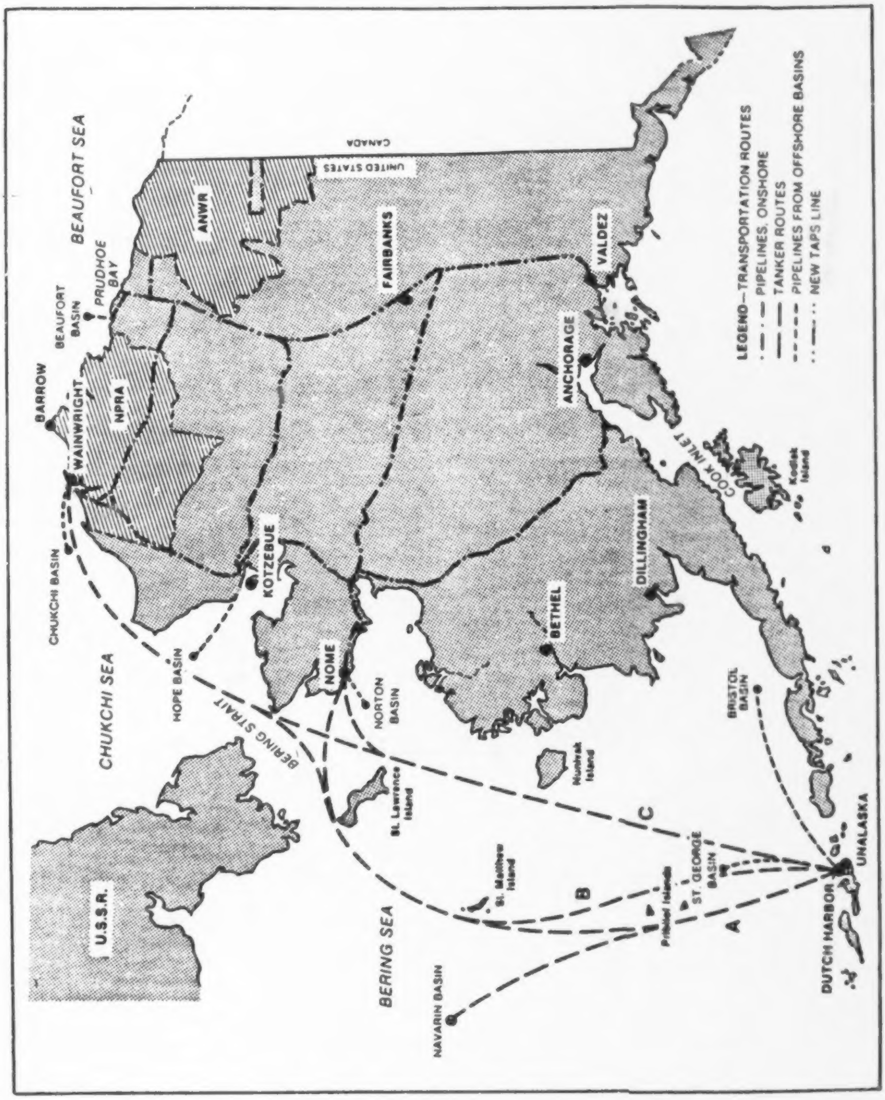
While the eight TAPS carriers now move all of the oil flowing from the Alaska North Slope, the prospect of competition from other forms of transportation cannot be ruled out. One potential alternative is tanker transport from the Beaufort Sea. The technical feasibility of this option has been recognized for a number of years but recently its

---

[1] Oil & Gas Journal (December 21, 1981) at 21-26.

Figure 9

POTENTIAL ARCTIC OIL TRANSPORTATION ROUTES


BEAUFORT SEA
CHUKCHI SEA
BERING SEA
BERING STRAIT
U.S.S.R.
CANADA
UNITED STATES
ANWR
NPRA
BARROW
WAINWRIGHT
BEAUFORT BASIN
PRUDHOE BAY
FAIRBANKS
VALDEZ
ANCHORAGE
COOK INLET
Kodiak Island
KOTZEBUE
CHUKCHI BASIN
HOPE BASIN
NOME
NORTON BASIN
BETHEL
DILLINGHAM
BRISTOL BASIN
Nunivak Island
St. Lawrence Island
St. Matthew Island
Pribilof Islands
ST. GEORGE BASIN
NAVARIN BASIN
A
B
C
DUTCH HARBOR
UNALASKA
LEGEND—TRANSPORTATION ROUTES
PIPELINES, ONSHORE
TANKER ROUTES
PIPELINES FROM OFFSHORE BASINS
NEW TAPS LINE

Source: National Petroleum Council.

economic attractiveness is also being accepted.[1] Dome Petroleum, a Canadian enterprise, has announced that it is considering plans to ship oil (and LNG) by tanker from the Beaufort Sea on a year-round basis over lanes to the east (through the Northwest Passage) and to the west (past the northern coast of Alaska and through the Bering Sea) for export to world markets. Recently Dome reiterated its plan, asserting that "There is not as much controversy on tankers versus a pipeline as some people make out."[2]

As development shifts from the Beaufort Sea reserves directly served by the TAPS carriers, and moves east and west from that site and into off-shore drilling locations, the potential for using tanker transport (or possibly new pipelines) is increased. If, as Figure 9 (based on a December 1981 report of the National Petroleum Council)[3] indicates, oil reserves in Alaska and tributary areas prove productive, the prospect is that new transportation systems will be developed. These may involve land pipelines (e.g., from Kotzebue to the Cook Inlet) or marine systems employing icebreaker tankers and operating from, say, the Chukchi Basin or the Bering Sea to a transloading facility at Dutch Harbor.[4] Depending on the location of the new crude oil sources, these alternative transport systems could prove considerably more efficient than attempts to use the existing TAPS facility, but the rates set by each TAPS owner today will influence shipper perceptions of the economic returns from these future transport systems. Since some developers of these reserves will have no ownership stake in TAPS, their concern will be securing transportation at the best price and offering the best service to meet their requirements. In the face of this expanded competition the TAPS carriers, with their long-term commitments and confronted with declining Prudhoe Bay Unit production, must, even in the short-term, set rates that will encourage exploration and prospective development of oil reserves in areas that they can serve.

---

[1] In a 1981 report the U. S. Geological Survey noted that marine systems have been "found to be technically and economically attractive for year-round service in the Arctic." Arctic Summary Report (Open-File Report 81-621) at 64.

[2] Oil and Gas Journal (October 17, 1983) at 67 and 70.

[3] U. S. Arctic Oil & Gas.

[4] Id. Chapter 5 and Appendix I. See also Figure 10, infra facing p. 34.

The Competitive Situation in Summary

Eight separate carriers operate via the TAPS line. Each carrier -- individually bearing financial obligations that extend into the next century -- must price even now with a view to encouraging exploration and development of new reserves that will in coming years replace declining oil output from the Prudhoe Bay Unit. As well, it must continue to price its services so that the ANS oil it transports remains competitive, in destination markets, with alternative domestic and foreign sources of crude.

IV

CONTINUED OIL PIPELINE RATE REGULATION, IN ALASKA AS WELL AS THE LOWER 48 STATES, IS NEITHER NECESSARY NOR DESIRABLE

The premise of the pending legislation is that competition makes continued oil pipeline rate regulation unnecessary. This is true both for oil pipelines in the Lower 48 states and for Alaska since, in each instance, the oil transported must compete for sale with other sources of crude supply that are independently transported and marketed.

More is involved, however, for it is not simply that regulation is economically anachronistic and administratively burdensome; it is also deleterious to the public's interest in the construction and expansion of pipelines that will be required in the long-run development of America's energy resources. Extant regulation, as has been carried out under the Federal Agency Regulatory Commission (FERC) auspices, has created a climate of uncertainty that threatens to discourage pipeline investment. It thus has had a broad negative impact, which decontrol would help correct.

Rate Regulation of Oil Pipelines Is Not Necessary

Prior discussion has shown that ANS oil competes in end-use U. S. markets with crude from other domestic and foreign suppliers in a market in which oil is now bountiful and declining in price (see Part II). Since it is this source competition that sets the price at which ANS oil can be sold, consumers are not endangered by the TAPS carriers or the producers operating on the North Slope, given the constraints of prevailing market conditions. In addition, competition governs the eight carriers which own the TAPS facility, since each carrier must consider the need to set rates to attract the traffic of shippers given the real prospect of declining ANS production (see Part III).

Reflecting this, oil pipeline rate regulation has not served to lower the delivered price of ANS crude. Nor would deregulation affect the delivered price. Moreover, none of the private-sector producers of ANS oil has even complained about the rates established by the eight TAPS carriers. The state of Alaska seeks to use regulation to gain lower pipeline rates but, strikingly and as discussed below, its aim is not to reduce the delivered price of ANS oil in domestic markets but rather to gain for itself additional royalty and tax income. Regulation, therefore, is not perceived by pipeline customers -- in Alaska and elsewhere -- as having any direct impact on the price at which oil is sold to refineries for processing and ultimate product sale to the public. This is indicative of the commanding role played by competition. It is also true, as discussed in Part III, that economic forces constrain pipeline rates vis-a-vis wellhead values for affiliated as well as independent producers of ANS crude.

Continuation of Regulation Ultimately Might Injure the State of Alaska

Since it is competition, not regulation, that governs the pricing of ANS oil, decontrol of Alaskan pipeline charges would have no effect on consumers. In this crucial respect there is no need for regulation to protect the American public. On the other hand, while the state of Alaska might initially benefit from regulation because of increased tax revenue, in the longer run, regulation would inhibit the development of pipeline capacity and would thereby dampen exploration and development of Alaska's oil resources.

If TAPS carriers are successful in inducing new development in nearby ANS areas, additional TAPS capacity may be required. The uncertainties created by regulation, however, may reduce the willingness of TAPS owners and affiliates -- as well as independent producers -- to participate in any additional (non-TAPS) pipeline ventures. Even independent producers, who might be thought to gain in the short-run from regulatory actions serving to increase the wellhead price of their crude, actually could be worse off as economic incentives to develop pipeline capacity are eroded. Regulation could thus inhibit development of ANS reserves, which in the long-run could be harmful, not only to the producers and carriers, but to the state itself. Such immediate gains in royalty and tax income as the state might realize under regulation could thus be secured at the expense of longer-term losses in revenue and inhibited development of Alaskan oil reserves.

Regulation Has Proven To Be Burdensome, Uncertain of Outcome, and Counter-Productive

Although some six years have passed since FERC assumed regulatory authority over oil pipelines, no final guidelines have been set forth by the Commission as to the rates which the TAPS carriers can charge. What has transpired is a lengthy hearing process that produced, at great expense, a mountainous record of documents and testimony. While a decision has been issued regarding rate regulation in the Lower 48 states, this ruling remains under litigation, and no decision has yet been reached by FERC as to the methodology it will use in reviewing rates published in TAPS tariffs.

The investigation of the TAPS carrier rates began in June 1977 when the Interstate Commerce Commission had jurisdiction (transferred to FERC on October 1, 1977). Phase I hearings before FERC began in February 1978 and continued until mid-March 1979. In all there were 125 days of hearings at which some 80 witnesses gave testimony. The record itself runs to 23,839 pages, with 945 exhibits. An initial decision of the Administrative Law Judge was issued February 1, 1980, from which appeals -- still pending -- were taken to ~~the~~ Commission. A hearing as to Phase II issues was begun in 1982, which continues, and Phase I has been reopened. to consider the application to TAPS of FERC's rate regulation methodology adopted for the Lower 48 states in 1982. In total, 324 days of hearings have been held with close to 50,000 pages of testimony inserted into the record.

In this setting, extant oil pipeline rate regulation -- as so sharply manifested by FERC's seemingly never-ending investigation of TAPS -- creates a heavy cloud of uncertainty hovering over the oil pipeline investment landscape. As things stand -- and as they have remained for nearly six years -- those who consider financial commitments for pipeline construction or expansion cannot now predict what rates they will be permitted to charge (and hence what revenue they can count upon). Moreover, even if at some unknown date in the future FERC were to articulate regulatory ratemaking criteria for TAPS, there can be no assurance that they might not later be changed.

Figure 10

POTENTIAL NEW SYSTEMS FOR THE TRANSPORTATION OF
CRUDE OIL FROM ALASKA AND TRIBUTARY SEAS

Basin Origin	Transport System	Estimated Land Pipeline Capital Costs ($ in billions)
Region I (On-shore, north of Brooks Range)	Pipeline to Wainwright	$ 1.421
	Wainwright to Dutch Harbor (Arctic Tanker)	
	or	
	Pipeline to Nome	7.855
	Nome to Dutch Harbor (Arctic Tanker)	
	or	
	Pipeline to Valdez	13.015
Region II (Bering Sea)	Nome to Dutch Harbor (Arctic Tanker)	
	or	
	Pipeline to Valdez	12.886
	or	
	Pipeline to Cook Inlet	10.400
	Arctic Tanker to Dutch Harbor Marine Pipeline to Dutch Harbor	
Region III (Beaufort & Chukchi Seas)	Wainwright to Dutch Harbor (Arctic Tanker)	
	or	
	Pipeline to Valdez	14.470
	or	
	Pipeline to Cook Inlet	15.062
	or	
	Pipeline to Nome	8.014
	Nome to Dutch Harbor (Arctic Tanker)	

Source: National Petroleum Council.

The unpredictable factors now associated with oil pipeline rate regulation are of general concern, but particularly in Alaska and adjacent areas. While this region is believed to contain large oil (and gas) reserves on-shore (in sections of the state often considerably removed from the presently operating Prudhoe Bay Unit) and in the surrounding waters (Chukchi Sea, Hope Basin, Norton Basin, Bering Sea, and the Beaufort Sea) -- those that will prove most susceptible to development cannot be forecast with certainty (see Figure 9, facing page 27). When development does take place, however, the National Petroleum Council has concluded that huge new investments in transportation systems will be required.[1] The precise configuration of new land pipelines cannot now be anticipated but lines in the western portion of Alaska -- perhaps extending south to the Cook Inlet -- may have to be built. As well, if reserves along the North Slope prove bountiful, there may be a need for an additional line in the TAPS corridor (construction of a new one million barrel per day pipeline from Prudhoe to Valdez is alone estimated to have a capital cost, in 1981 dollars, of $10.7 billion). As indicated in Figure 10, the cost of building new land oil pipelines ranges upward to $15 billion. This, it should be noted, would be in addition to the cost of necessary marine oil transport systems.

The climate of uncertainty created by regulation is detrimental to pipeline investment of the sort that has to be contemplated in Alaska and elsewhere. Since pipelines play a major role in developing energy resources (and in making oil available for distribution throughout the country), the inhibiting effects of regulation are potentially devastating given the desire of the United States to make greater use of its domestic oil.

---

[1] U. S. Arctic Oil & Gas Chapter 5 and Appendix E, pp. E-7 to E-29.

CONCLUSION

Just as is true of those who operate pipelines in the Lower 48 states, the eight TAPS carriers face competition, including that of other foreign and domestic sources of oil supply. These key ingredients of competition, already intense, have become increasingly so in the face of an abundance of oil contesting for sale in world markets. Further, TAPS carriers must establish rates today to encourage development of new ANS sources (as Prudhoe Bay Unit production declines).

In this setting competition not only sets the price paid by petroleum consumers but also can be relied upon to discipline the rates that oil pipeline carriers can charge for their services. Regulation, in Alaska as well as the Lower 48 states, is unnecessary. More than that, however, decontrol of oil pipeline rates would remove what has proven to be an administratively burdensome and costly form of regulation that has created unnecessary risks for future pipeline investments. By eliminating oil pipeline rate regulation throughout the United States, and relying instead on competitive market forces, these risks would be removed and productive pipeline investment, vitally important to the development and efficient use of the nation's oil reserves, would be encouraged.

STATEMENT OF KENNETH P. FOUNTAIN, OFFICER AND DIRECTOR, EXXON PIPELINE CO.

Mr. Chairman and members of the subcommittee, my name is Kenneth P. Fountain. I am an Officer and Director of Exxon Pipeline Company. Exxon Pipeline Company, in addition to operating extensive oil pipelines throughout the lower 48 states including offshore areas, is one of the eight Owners of the Trans Alaska Pipeline System (TAPS). Exxon Pipeline operates its interest in TAPS as a separate common carrier totally distinct from the other seven Owners. The other Owners operating as separate common carriers in RAPS are Amerada Hess Pipeline Corporation, ARCO Pipe Line Company, BP Pipelines Inc., Mobil Alaska Pipeline Company, Phillips Alaska Pipeline Corporation, Sohio Pipe Line Company, and Union Alaska Pipeline Company.

Exxon Pipeline Company is also a member of the Association of Oil Pipe Lines (AOPL) and strongly supports the statement of Mr. Donald R. Merriman on behalf of the AOPL and the supporting statements of Professor Edward J. Mitchell and Mr. Richard J. Barber. These statements clearly show that there is no public interest to be served by continued regulation of the pipeline industry. Governmental regulation should only be imposed on an industry to protect the public interest and/or act as a substitute for the free market place where none exists. I think the record is clear that neither criterion is applicable to this industry and therefore the need for regulation does not exist. Exxon Pipeline urges this Committee to consider H.R. 2677 favorably.

In addition to our support of the AOPL, Exxon Pipeline is here today to address one aspect of the position of the Administration on oil pipeline deregulation. As we understand it from prior hearings before the Congress, the position of the Administration is a three-part proposal. First, the administration proposes the total deregulations of oil pipelines as opposed to the limited economic deregulation supported by AOPL; second, the Administration proposes that oil pipelines be subject to reregulation based on a "market power" or "market dominance" concept; and third, the Administration proposes the exclusion of TAPS from deregulation even with the reregulation concept.

Although it has been over a year since the Administration made its first and second proposals, it has not made public any further delineation of these proposals. Without the specific proposals, it is premature to comment. We would like, however, to address the third proposal, i.e., exclusion of TAPS from any deregulation. There the Administration, with no meaningful study or other supportive data, simply proposes a congressional fiat that the eight TAPS carriers should not be accorded the same treatment as other oil pipeline carriers. This, in our opinion, is simply unfair; is based on misconception; has no consumer or public interest basis; defeats the purpose of oil pipeline deregulation; and sends a message of uncertainty to potential investors in major oil pipeline projects.

We feel very strongly that a principal objective of the proposed legislation is to encourage expansion of the U.S. oil pipeline transportation system, especially in the frontier areas which will become increasingly important to future U.S. energy supply. These frontier areas include not only onshore areas such as the Overthrust Belt and the Tuscaloosa Trend, but also offshore and Alaska areas. To take Alaska as an example, the National Petroleum Council (NPC) has indicated that the undiscovered oil and gas resource base in the Artic may encompass as much as 40 percent of the total undiscovered recoverable oil and gas resources remaining within the jurisdiction of the U.S. For oil alone, the NPC estimates that as much as 50 percent may occur in the U.S. Arctic. If the National Petroleum Council study is right about the extent of Alaska's oil and gas resources, and if these resources are indeed discovered, then over the next 40 to 50 years petroleum companies could spend almost $300 billion in 1981 dollars on development, transportation, and operating expenses—and this doesn't even count lease bonuses and unsuccessful exploration costs. If growth potential such as this is to be realized beyond the current Prudhoe Bay activity, a business climate which attracts the proper level of investment is needed. Government regulations will play a major role in creating that environment.

Even with current economic conditions, imports are required to meet one-third of U.S. petroleum needs. Projections are that this import share of total U.S. needs will increase to more than half by 1990. In addition, production from existing conventional domestic oil reserves will decline by about 60 percent over the next 20 years. To displace imports and replace domestic production, a very substantial effort will be required in frontier areas. Transportation will therefore play a major role in getting the needed oil to market. In frontier areas transportation by pipeline can be the most economical and environmentally acceptable means to transport crude oil to market. The oil pipeline industry needs to be a major factor. But to meet the challenges, vast amounts of capital and new technology will be required.

There are a lot of "ifs" in the future of oil production and transportation in Alaska and U.S. Arctic areas. However, one certainty is that the "ifs" grow larger without a healthy business and investment climate. If the oil pipeline industry is to attract the necessary capital to compete in these frontier areas, economic regulation should be eliminated. Exxon Pipeline believes that the exclusion of the eight TAPS carriers from deregulation will have an adverse impact on new frontier pipelines and expansions of existing lines and, therefore, an adverse impact on consumers.

Investors operate on perception of risks. One of the risks is regulation. TAPS is an important example of a frontier pipeline which is besieged by an oppressive requlatory climate. For this reason, in frontier areas, TAPS is the standard by which investors must judge investment risks. In addition to facing extraordinarily high business risks, TAPS has been the most over-regulated project in history. Investors may not have forgotten the trials and tribulations that the Owners of TAPS had to overcome to make the project a reality. Moreover, a FERC Administrative Law Judge sent an even more economically discouraging message in his initial decision in Phase I of the TAPS rate proceeding. Likening an investment in TAPS with an investment in long-term government securities, he structured a regulatory methodology which simply makes an investment in TAPS uneconomic. The message to potential investors in other major frontier pipeline projects is clear. Even if a project is a technical and operational success, regulation can turn it into a bad investment.

Years ago Congress faced up to the prospect that TAPS would not be built by enacting the Trans Alaska Pipeline Authorization Act. Congress is now faced with the prospect that the economic regulation of TAPS will destroy the economics of that investment and thereby create an even greater uncertainty for future projects in the Alaskan frontier. Just as there were proponents that TAPS should not be built there are now proponents that TAPS should be singled out from the pipeline industry for more restrictive treatment. TAPS is the largest private project in the world. Its technological success, environmental accomplishments, and contribution to the balance of payments and the energy self-sufficiency of this nation have proved Congress right in enacting the TAPS Act. Likewise, the deregulation of TAPS and the projects that such deregulation will foster will again prove Congress right when it enacts H.R. 2677. The continued high level of long-term interest rates, despite lower inflation, demonstrates the difficulty in changing investors' perception. It cannot be done overnight. Oil pipeline investors need a signal from Congress now. Excluding TAPS from deregulation would be the wrong signal.

We believe that the Administration's position on TAPS is based on a total misconception of how TAPS is organized and operated. The most common misconception about TAPS is that it is a single entity operating as a single pipeline carrier. It is not. TAPS is eight pipeline carriers operating in a single pipeline system physically operated and maintained by Alyeska Pipeline Service Company. Each pipeline carriers owns a discrete amount of the TAPS mechanical capacity and operates its own pipeline business, posting its own tariffs, soliciting tenders, billing and collecting from its shippers completely independently of the other TAPS carriers. These facts are simply ignored by those who would label TAPS a "natural monopoly." The advantage of physically combining capacities into a single pipeline system to provide transportation at a much lower cost is not unique to TAPS, but is also used in a number of lower 48 pipelines. The statement submitted by Mr. Frank Turpin, President of Alyeska, describes in more detail the role of Alyeska.

As noted by Mr. Merriman speaking on behalf of the AOPL, Mr. Richard J. Barber, a recognized expert in transportation matters, is providing testimony to the Committee regarding his study, "The Transportation of Alaskan North Slope Oil by Pipeline: An Assessment of the Competitive Issues Relevant to Rate Deregulation." Mr. Barber is in a position to address issues related to the competitive environment within which TAPS operates.

Thank you for this opportunity to submit this statement on a matter which is so critical to the nation's economy and security. Exxon Pipeline urges early and favorable consideration of H.R. 2677 by the Subcommittee and is prepared to supply additional information or work with the Subcommittee as appropriate.

Mr. ANDERSON. Please proceed.

TESTIMONY OF RICHARD J. BARBER, ECONOMIC CONSULTANT, TRANS ALASKA PIPELINE, AND KENNETH FOUNTAIN, GENERAL COUNSEL, EXXON PIPELINE CO.

Mr. **Fountain**. If it pleases the committee, Mr. Chairman, I will go first.

My name is Kenneth P. Fountain. I am an officer and director of Exxon Pipeline Co.

I have a statement that I have filed that will be printed in the record, I assume. I will not spend a lot of time going over my prepared statement.

Mr. **Fountain**. Exxon Pipeline Co., in addition to operating extensive oil pipelines throughout the Lower 48 States including offshore areas, is one of the eight owners of the Trans Alaska Pipeline System.

Exxon Pipeline operates its interest in TAPS as a separate common carrier totally distinct from the other seven owners.

The other owners operating as separate common carriers in TAPS are Amerada Hess Pipeline Corp., ARCO Pipeline Co., BP Pipelines, Inc., Mobil Alaska Pipeline Co., Phillips Alaska Pipeline Corp., Sohio Pipe Line Co., and Union Alaska Pipeline Co.

Exxon is a member of the Association of Oil Pipe Lines and of course adopts the statements made yesterday by Mr. Merriman and those on behalf of the AOPL. We are here today to speak specifically to issues raised about the Trans Alaska Pipeline System, and Frontier Pipeline Systems specifically.

Yesterday we learned for the first time a little more of the details about the administration proposal for deregulation of oil pipelines. We have heard a lot of these today. I would like to approach the problem from a little different direction and start by saying that we believe, and we assume that as a policymaking body for this country that one of the reasons that you are considering deregulation of oil pipelines is to foster construction of oil pipelines.

I have been listening for 2 days trying to find one single thing that maybe everybody here could agree on.

The only thing that I think that both sides agree on is that pipelines are a very efficient means of transporting petroleum and its products, and you need pipelines if you are going to have an effective energy supply to this country.

Now, if you—we all agree that pipelines are good. I guess the problem we have is, who is going to pay for them and how are they going to get paid for, which, again, I come back to a rhetorical question. If the purpose of this legislation is to encourage building new pipelines, and I submit that is what we have heard so far, then the administration proposal is upside down.

We heard the administration talk about doing competition studies in certain areas, and eliminating so many pipelines that are probably competitive, and, again, for one who has not seen the study, but what I would conclude or infer from that is that areas that are older, fully developed, are competitive, so we can deregulate them.

What are the areas we are going to keep regulating? We are going to regulate the frontier areas in Alaska. We are going to regulate the offshore areas. We are going to regulate pipelines exactly where we want to get them built.

Now, another rhetorical question. Who is going to build them?

Again, historically the only people who have built or had an interest in building frontier pipelines are the producers who found the reserves in frontier areas.

So they have constructed, through subsidiary companies the pipelines. Until recently the investors who put the money in those pipelines were looking at a regulatory scheme that has been referred to as light-handed by some, nonexistent by others.

But, whatever, the people who built the TAPS, the people who built the offshore pipelines, the people who are going to be looking at building the pipelines that are going to connect up the next reservoirs that are found in this country of any significance, they looked at a system that said that you can earn enough money to attract capital.

Now we are hearing that if there is going to be a pipeline built in a new area, and again, if I understand the way it has been defined by Mr. Baxter and others who appeared yesterday, we are talking about a pipeline that is going to have, in their definition axiomatically, market dominance.

If you have a new field and build a pipeline to it, it is going to be market—have market power, as they say. Now, they say if that happens, then that has to be a public utility. What is wrong with a public utility?

Well, what is wrong with a public utility is, oil pipelines aren't public utilities. The interesting thing about public utilities are, as we have heard some discourse here, public utilities have franchised areas. The regulator can say you can charge this much in this area, and anybody that uses that has to pay that much.

With oil pipelines, all they can do is say you can charge no more than this, but nobody can guarantee that that pipeline is going to collect the bottom line. In other words, pipeline in this semicompetitive market that we have been hearing about, it is neither fish nor fowl, but one thing is for sure, under a utility concept, an investor in a pipeline cannot be assured any kind of return by the regulator. All it can be assured by the regulator is a limit on what its return is.

So I say again, who is going to invest in the pipelines, and if the purpose of the legislation you are considering is to encourage pipelines in the areas that are going to help this Nation develop its petroleum resources, you need to consider adequate returns to the people who are going to make those investments.

The point I made about the investors in frontier pipelines being the producers who find the resources is another basic point. They have alternative places to put their money.

I don't think anybody here thinks that anybody in the producing business is going to be looking for a rate of return that is the same as taking his money and putting it down in the bank. You just don't put your money in securities. I use that term for this reason. In the TAPS rate case that has been going on for 6 years, as you have been told today, in the first decision by the administrative law judge, that is exactly how he set the rate of return for the TAPS pipeline owners—at the rate of a Government security.

Now, what investors are going to go out, take a chance on putting $9 billion in the ground in Alaska with the idea—to get the same amount of return they can get from putting the money over here in the Riggs National Bank?

It just doesn't make sense to me.

Also, yesterday we heard the State of Alaska witness refer to some testimony that the State had introduced in the TAPS rate case, and then he talked about some terrible calamities that were going to occur if the TAPS pipeline rates were not reduced, or if the TAPS pipelines were not regulated like an electric utility.

It is interesting that these conclusions that he drew are based upon three computer models. The computer models like any other models, are based on what kind of assumptions you plug into them.

It is also interesting that he talks about how that, if the TAPS rates are not reduced, then it is going to do two things.

No. 1, it is going to cost the consumer more money on the bottom end, and, No. 2, it is going to lower the wellhead rate on the top end.

In other words, if the TAPS rates are not adjusted, it is going to cause an effect on both ends.

That is interesting because I think he also later said that the price of crude in the United States was set not by Alaska crude, but set by the marginal barrel which is an imported barrel.

But, in any event, I don't have a computer model. But I would like to say in this case, since TAPS has been there for 7 years, I do have a little bit of factual information that I would like to supply to the committee for your consideration.

It was been raised by Mr. Blum the fact that we just don't have any independents operating on the North Slope, or other than TAPS-connected producers. Since October 13, 1982, in Lease Sale 71, the following producers who have no affiliation at all with TAPS have successfully acquired leases in the North Slope:

Amoco, Chevron, Cities Service, Diamond Shamrock, FINA, Getty, Gulf, Koch, Marathon, Ocean Drilling, Murphy Oil, Placid Oil, Pennzoil, Shell, Sun, Tenneco, Texaco.

That list contains some major oil companies. That list contains some smaller independent oil companies.

But query: If these people—and they are not little old ladies in tennis shoes—were concerned about the level of the TAPS rates, why are they up there investing millions of dollars to acquire tracts to do exploration and production?

It just doesn't follow. We are not talking about a computer model now. We are talking about facts.

Independents are acquiring and exploring to develop leases on the North Slope.

Mr. Anderson. Can we have a copy of that document for the record?

Mr. Fountain. That document is some notes I got yesterday by telephone. It is a matter of public record, Mr. Chairman. I can type it up and supply it to you if you like.

Mr. Anderson. Yes, we would like that.

[The question posed by Representative Anderson and response received from Mr. Fountain follow:]

Mr. ANDERSON. Please provide for the record a list of companies not affiliated with any TAPS Owner submitting winning bids and thus acquiring leases on the Alaskan North Slope.

Mr. FOUNTAIN. From the information available to me, the following companies not affiliated with any TAPS Owner have been successful bidders on the Alaskan North Slope:

Conoco Inc.
Getty Oil Co.
Tesoro Inc.
Placid Oil Co.
Chevron U.S.A. Inc.
Tenneco Oil Co.
Murphy Oil Corp.
Gulf Oil Corp.
Amoco Production Co.
Shell Oil Co.
Elf Aquitaine
Texas Gulf Inc.
Diamond Shamrock Corp.
Hamilton Bros. Co. Inc.
Texas Eastern Exploration Co.
Koch Industries Inc.
Rowan Petroleum Inc.
Koniag Inc.
Pennzoil Oil & Gas Inc.
Finadel Inc.
Sealaska Corp.
Cook Inlet Region, Inc.
Nova Regional Corp.
Marathon Oil Corp.
Dyko Petroleum
Alaska Land Leasing Co.
Geopol, Inc.
Cities Service Co.
Sun Oil Co.
Ocean Drilling

Mr. FOUNTAIN. Now, another point that the State made yesterday was their concern for loss of revenue. Now, that is one thing I can certainly appreciate, and I think this committee needs to keep it in context, why they are so concerned about their revenue.

In 1982 the State of Alaska received 94.9 percent of its total revenue from the oil business.

Now, again, to put that kind of revenue in the context of your constituents, the State of Alaska's per capita revenue, after being adjusted for differences in cost-of-living, is approximately 6 to 1.

In other words, the State of Alaska collects revenues—95 percent from the oil business—in excess of $10,000 per person. Adjusted in the State, in which your constituents live, the average Lower 48 revenue revenue runs maybe $1,700, $1,800 per person.

In other words, about a 6-to-1 ratio.

This problem that the State has about its oil revenues is probably best illustrated by its past Governor, Mr. Hammond. He made a speech in December 1980 in a prelegislative conference at the Alaska State Chamber of Commerce.

I would like to quote an excerpt from that speech:

> With income tax elimination, we have taken the vast majority of productive Alaskan taxpayers out of the tax base, thus narrowing it, rather than broadening it. In the process, we have increased our dependency on oil, and have made it far more difficult for any new development, particularly that which attracts new population, to possibly pay its own way.

Finally, with no income tax, there is now little public perception that new programs cost anything. Demands for them have increased exponentially, even from those who, when paying taxes, protested their passage.

Now, I submit that the State of Alaska is concerned about its oil revenue because without it, it would not be able to afford to have repealed its personal income tax and other taxes and this past year, I believe in 1982, paying each of its citizens a thousand dollars dividend from their tax revenues, and this year, 1983, somewhat less, and probably that is enough said about that.

Let me just wind up by saying that I looked for something good in what I heard today. And someone did say that the TAPS was a fantastic technological accomplishment.

Mr. Wolf, in his questions yesterday referred to the difficulties we had getting the TAPS pipeline authorized to be built.

When we were trying to build a TAPS pipeline, we had a tremendous number of people who tried to thwart that operation. The TAPS pipeline is built, and now we have a tremendous number of people who are trying to make that project an uneconomical investment for those who took those risks.

I thank you, sir, for the opportunity to address you—oh, pardon me. There was one other thing I wanted to address before I wound up.

This morning Congressman Bedell made some remarks and he drew some conclusions that unfortunately I think were based on some erroneous information that he had.

I have too many pieces of paper, if you will excuse me.

When we became aware of the letter that Mr. Bedell attached to his statement this morning, I had a letter delivered to Mr. Bedell back on November 3, where I tried to point out in what ways the information that he was relying on was in error, and it was significantly in error.

I would like, with your concurrence, sir, to tender my letter into the record.

Mr. ANDERSON. Objection?

So ordered.

[The letter referred to follows:]

EXXON PIPELINE COMPANY
POST OFFICE BOX 2220 HOUSTON, TEXAS 77001

KENNETH P. FOUNTAIN
GENERAL COUNSEL

November 3, 1983

Honorable Berkley Bedell
Chairman, Subcommittee on General
Oversight and the Economy
Committee on Small Business
House of Representatives
Washington, D.C. 20515

Dear Chairman Bedell:

We have been furnished a copy of the letter you received from the Federal Energy Relgulatory Commission responding to your request for information on the carriers operating in the Trans Alaska Pipeline. We reviewed the data furnished you for Exxon Pipeline Company. (Specifically page 3 of Schedule B, Attachment I.) While the information presented was based on testimony filed in the TAPS rate case, the rates of return calculated by FERC Staff using parts of these data are grossly misleading and in some cases, wrong.

We have attached a tabulation of data extracted from Exxon Pipeline's testimony in the rate case. For ease of comparison, we have arranged the format in this Attachment II to correspond to that furnished you by FERC.

In the FERC document the first column purports to be Exxon Pipeline's position and the next two columns the State of Alaska and the FERC Staff positions respectively. Our Attachment II similarly contains the pipeline position in the first column. The second column of Attachment II is a tabulation of data adjusted to conform to the depreciated original cost methodology used by both the State and FERC Staff and is directly comparable to both the second and third columns in the FERC document. You will note the disparities between the two documents.

There are three major reasons that explain why the rates of return calculated by FERC Staff vary so greatly from those calculated by Exxon Pipeline Company.

First, referring to the "rate base claimed" line, the difference shown is a result of two factors. One is the methodology employed. The Company position utilizes valuation, the methodology utilized for regulation of oil pipelines for more than 40 years, to determine the appropriate rate base. The State and FERC utilize a depreciated original cost methodology. While this concept has a long history of application in public utility regulation, it has never been utilized in the federal regulation of common carrier oil pipelines and is completely inappropriate. The second factor that explains this difference in rate base is the arbitrary reduction in the original cost of the pipeline construction reflecting both the State and the Staff's contention that part of the original cost of the pipeline facility should be disallowed ($400 million and $130 million, respectively) as imprudently incurred. It should be noted that the Commission in its Williams decision did affirm valuation as the proper rate base for oil pipelines generally, but the issues of methodology (valuation versus depreciated original cost) and imprudent investment have not been decided. It is presumptuous of the Staff to decide these issues for themselves.

The other major reason for the difference in calculated rates of return is that the Staff simply made an error in not recomputing the "income taxes claimed" for the cases displayed in columns two and three in the FERC document.

While there are numerous other factors that could account for differences in rate of return calculations, these three are the most significant and certainly the most obvious.

We appreciate your concern that just and reasonable tariffs be determined for the TAPS carriers. We believe that Exxon Pipeline Company's rates reflect a fair rate of return on the value of its investment in TAPS and particularly so in view of the risks attendant to what has been described as one of the greatest construction projects ever undertaken by private industry.

Should you desire to pursue the issues raised in the FERC letter in more detail, I and appropriate members of Exxon Pipeline's staff would be happy to meet with you and your staff at your convenience.

Sincerely,

KPF:jo
Enclosures
copies: Representative Richard Ray
Representative Robin Britt
Representative Norman Sisisky
Representative Silvio Conte, Ranking Member
Representative Michael Bilirakis
Representative Sherwood Boehlert
Representative Dan Schaeffer

EXXON PIPELINE COMPANY
Rate of Return

	Company Position	State of Alaska Position	FERC Staff Position
1980			
Revenues	$ 696,124	$ 696,124	$ 696,124
Operating Expenses	170,098	153,413	157,186
Income Taxes Claimed	217,946	28,426	51,262
Carrier Income	308,080	514,285	487,676
Rate Base Claimed	1,879,600	1,157,602	1,360,843
Rate of Return	16.39%	44.43%	35.84%
1981			
Revenues	$ 695,997	695,997	$ 695,997
Operating Expenses	175,465	157,051	161,701
Income Taxes Claimed	231,695	50,442	56,286
Carrier Income	288,846	488,504	478,010
Rate Base Claimed	1,842,510	$1,115,888	1,296,687
Rate of Return	15.68%	43.78%	36.86%
1982			
Revenues	$ 633,512	$ 633,512	$ 633,512
Operating Expenses	170,069	137,985	142,492
Income Taxes Claimed	215,950	15,883	36,711
Carrier Income	247,493	479,644	454,309
Rate Base Claimed	2,081,591	1,049,663	1,225,627
Rate of Return	11.89%	45.70%	37.07%

ATTACHMENT I

RECD NOV 3 1983

EXXON PIPELINE COMPANY
$(000)

1980	Valuation Methodology(1)	Original Cost Methodology(2)
Revenues	696,124	696,124
Operating Expenses	170,099	179,890
Income Taxes	215,950	243,476
Carrier Income	310,075	272,758
Rate Base	2,044,456	1,719,061
Rate of Return	15.2%	15.9%
1981		
Revenues	695,997	695,997
Operating Expenses	175,455	185,371
Income Taxes	222,322	247,381
Carrier Income	298,220	263,245
Rate Base	2,108,825	1,588,292
Rate of Return	14.1%	16.6%
1982		
Revenues	633,512	633,512
Operating Expenses	164,281	171,239
Income Taxes	198,364	223,178
Carrier Income	270,867	239,095
Rate Base	2,158,777	1,503,268
Rate of Return	12.5%	15.9%

Source: Prepared Direct Testimony of Samuel A. Flint on Methodology and Rate of Return - August 1, 1983 and Supplemental Revisions

(1) Exhibits SAF-2 and SAF-3
(2) Exhibit SAF-5

Mr. FOUNTAIN. I have also received today a copy of a letter that Mr. Sousa, the Acting Chairman at FERC, has written to Congressman Bedell.

If you will, I would like to read a brief excerpt from it:

> Therefore, I cannot assure you unequivocally that Schedule B contains accurate information, or reflects the positions of the parties. In any event, reliance on the figures in Schedule B as representative of the true return to the TAPS owners prior to a commission decision on the merits of the contested issues would be inappropriate.

With your concurrence, sir, I would like to likewise tender this letter for the record.

Mr. ANDERSON. It will be made a matter of the record. No objection?

So ordered.

[The letter referred to follows:]

FEDERAL ENERGY REGULATORY COMMISSION,
Washington, D.C., November 9, 1983.

Hon. BERKLEY BEDELL,
Chairman, Subcommittee on General Oversight and the Economy, Committee on Small Business, House of Representatives, Washington, D.C.

DEAR CHAIRMAN BEDELL: The Commission has recently received several inquiries expressing concern over the possible misinterpretation of the information contained in my letter to you dated October 19, 1983. The attachment marked Schedule B seems to be of particular concern.

In your letter to former Chairman Butler dated September 21, 1983, you requested that the F.E.R.C. furnished rate of return figures on the largest owners of the Trans Alaska Pipeline System (TAPS). Schedule B was intended as a response to that request. Unfortunately, Schedule B was mischaracterized on the first page of my letter. Schedule B does not contain the rates of return earned by the owners. Rather, Schedule B purports to contain figures which were represented to me by Commission staff as those presented by the various parties in the pending TAPS rate case.

Today, staff advised me that the rate of return figures attributed to the State of Alaska and the F.E.R.C. (trial) stafff were not presented by those parties. In addition, staff has informed me that there may be a mismatch between the revenues and the income taxes claimed. There is also a question on the appropriate method for determining the tax figure itself. Therefore, I cannot assure you unequivocally that Schedule B contains accurate information, or reflects the positions of the parties. In any event, reliance on the figures in Schedule B as representative of the true return to the TAPS owners prior to a Commission decision on the merits of the contested issues would be inappropriate. Likewise, any attempt to develop an actual rate of return at this time would be futile.

My attention has also been brought to a number of typographical errors in the other schedules attached to my October 19, 1983 letter. Those errors have been corrected, and I am attaching corrected copies. Additionally, the schedules have been revised to note the source of the figures shown. Because of the pendency of the rate case, the figures contained in the revised schedules are subject to contest and change.

I appreciate that you would like more specific information than contained in the materials enclosed. However, to provide such information would require my evaluating the merits of the positions of the parties now arguing the case. I am confident that you understand that I am constrained from making that evaluation, until the case comes before the Commission after the hearing has been completed.

It was certainly not my intention to misinform or mislead you or any other interested party. I trust that the enclosed corrections, the revised schedules and my comments will remedy any misconceptions that may have been formed.

Sincerely,

A. G. SOUSA,
Acting Chairman.

Enclosure.

AMERADA HESS PIPELINE CROP.—PLANT INVESTMENT, OPERATING AND INTEREST EXPENSES, DEBT SERVICE COST

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
Total investment [1]	144,985			
Accrued depreciation	15,626			
Net plant [1]	129,359			
Operating expenses		13,971	14,429	12,264
Interest expenses [2]		6,079	4,568	3,068
Debt service cost [3]		11,306	9,820	8,348

[1] Investment includes construction work in progress.

[2] Per income statement.

[3] Includes interest costs.

Source: FERC form P (now FERC form 6).

Note.—All stated amounts are at issue before an FERC administrative law judge in the pending TAPS rate case, docket No. OR78-1.

ARCO PIPELINE CO.—PLANT INVESTMENT, OPERATING AND INTEREST EXPENSES, DEBT SERVICE COST

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
Total investment [1]	1,963,042			
Accrued depreciation	177,311			
Net plant [1]	1,785,731			
Operating expenses		198,939	206,672	178,978
Interest expense [2]		129,129	130,390	89,035
Debt service cost [3]		157,692	322,997	487,551

[1] Investment includes construction work in progress.

[2] Per income statement.

[3] Debt service costs were estimated from information contained in FERC form P (now FERC form 6) and/or annual reports filed with the Alaska Pipeline Commission or the Alaska Public Utility Commission.

Source: Alaska Pipeline Commission Annual Report; Alaska Public Utility Commission Annual Report.

Note.—All stated amounts are at issue before an FERC administrative law judge in the pending TAPS rate case, docket no. OR78-1.

BP PIPELINES, INC.—PLANT INVESTMENT, OPERATING AND INTEREST EXPENSES, DEBT SERVICE COSTS

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
Total investment [1]	1,498,823			
Accrued depreciation	143,131			
Net plant [1]	1,355,692			
Operating expenses		149,867	153,491	138,122
Interest expenses [2]		103,330	97,294	92,071
Debt service cost [3]		129,232	149,908	144,919

[1] Investment includes construction work in progress.

[2] Per income statement.

[3] Includes interest costs.

Source: FERC form P (now FERC form 6).

Note.—All stated amounts are at issue before an FERC administrative law judge in the pending TAPS rate case, docket No. OR78-1.

EXXON PIPELINE CO.—PLANT INVESTMENT, OPERATING AND INTEREST EXPENSES, DEBT SERVICE COSTS

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
Total investment [1]	1,830,476			
Accrued depreciation	178,826			
Net plant [1]	1,651,650			
Operating expenses		182,190	188,745	168,480
Interest expenses [2]		111,035	100,468	99,654
Debt service cost [3]		270,829	260,110	110,154

[1] Investment includes construction work in progress.

[2] Per income statement.

[3] Debt service costs were estimated from information contained in FERC form P (now FERC form 6) and/or annual reports filed with the Alaska Pipeline Commission or the Alaska Public Utility Commission.

Source: Alaska Pipeline Commission Annual Report; Alaska Public Utility Commission Annual Report.

Note.—All stated amounts are at issue before an FERC administrative law judge in the pending TAPS rate case, docket No. OR78-1.

MOBIL ALASKA PIPELINE CO.—PLANT INVESTMENT, OPERATING AND INTEREST EXPENSES, DEBT SERVICE COSTS

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
Total investment [1]	461,469			
Accrued depreciation	45,206			
Net plant [1]	416,263			
Operating expenses		45,767	40,110	36,017
Interest expenses [2]		28,967	28,863	28,788
Debt service cost [3]		28,959	28,950	28,951

[1] Investment includes construction work in progress.

[2] Per income statement.

[3] Includes interest costs.

Source: FERC form P (now FERC form 6).

Note.—All stated amounts are at issue before an FERC administrative law judge in the pending TAPS rate case, docket No. OR78-1.

PHILLIPS ALASKA PIPELINE CORP.—PLANT INVESTMENT, OPERATING AND INTEREST EXPENSES, DEBT SERVICE COSTS

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
Total investment [1]	146,409			
Accrued depreciation	14,811			
Net plant [1]	131,598			
Operating expenses		13,353	11,555	9,958
Interest expenses [2]		10,066	10,027	9,997
Debt service cost [3]		10,364	10,275	10,080

[1] Investment includes construction work in progress.

[2] Per income statement.

[3] Includes interest costs.

Source: FERC form P (now FERC form 6).

Note.—All stated amounts are at issue before an FERC administrative law judge in the pending TAPS rate case, docket No. OR78-1.

SOHIO PIPE LINE CO.—PLANT INVESTMENT, OPERATING AND INTEREST EXPENSES, DEBT SERVICE COSTS

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
Total investment [1]	3,181,669			
Accrued depreciation	305,996			
Net plant [1]	2,875,673			
Operating expenses		299,052	285,032	269,707
Interest expenses [2]		239,655	227,137	215,508
Debt service cost [3]		294,543	338,140	327,189

[1] Investment includes construction work in progress.

[2] Per income statement.

[3] Debt service costs were estimated from information contained in FERC form P (now FERC form 6) and/or annual reports filed with the Alaska Pipeline Commission or the Alaska Public Utility Commission.

Source: Alaska Pipeline Commission annual report; Alaska Public Utility Commission annual report.

Note.—All stated amounts are at issue before an FERC administrative law judge in the pending TAPS rate case, docket No. OR78-1.

UNION ALASKA PIPELINE CO.—PLANT INVESTMENT, OPERATING AND INTEREST EXPENSES, DEBT SERVICE COSTS

[In thousands of dollars]

	January 1, 1980	1980	1981	1982
Total investment [1]	146,106			
Accrued depreciation	14,009			
Net plant [1]	132,097			
Operating expenses		13,704	212,388	10,198
Interest expenses [2]		8,364	8,053	7,561
Debt service cost [3]		8,331	13,689	13,260

[1] Investment includes construction work in progress.

[2] Per income statement.

[3] Includes interest costs.

Source: FERC form P (now FERC form 6).

Note.—All stated amounts are at issue before an FERC administrative law judge in the pending TAPS rate case, docket No. OR78-1.

TRANS ALASKA PIPELINE SYSTEM—INTERSTATE TARIFF RATES

[Per barrel]

Owner company	ICC tariffs [1]	Filed tariffs [2]
Amerada Hess Pipeline Corp	$4.85	$6.44
ARCO Pipleine Co.[5]	4.91	6.04
BP Pipelines, Inc.[5]	4.68	[3] 6.35/5.40
Exxon Pipeline Co	5.10	[4] 6.27/5.30
Mobil Alaska Pipeline Co	4.84	6.31
Phillips Alaska Pipeline Corp	4.83	6.22
Sohio Pipe Line Co	4.70	6.16
Union Alaska Pipeline Co	4.89	6.09
Weighted average rate	4.84	6.20

[1] In effect from date of initial service to expiration of the ICC susepnsion period during January 1978.

[2] In effect subsequent to the ICC suspension period.

[3] BP reduced its rate to $5.40 per barrel from July 1, 1982, to Nov. 1, 1983.

[4] Exxon reduced its rate to $5.30 per barrel from Jan. 1, 1982, to Oct. 19, 1983.

[5] Exxon and BP levy a surcharge for oil originating in the Kuparuk Reservoir.

Mr. ANDERSON. We will hold any questions until after we hear from Mr. Barber.

Mr. Barber.

Mr. BARBER. Mr. Chairman, I thank you for allowing me to appear before you and I know that you have been hearing a great many views in these last 2 days, but the hour is getting somewhat late and I know that you would appreciate brevity.

So I will try to be very brief.

You have a copy of my short prepared statement and of our report, which you have put into the record.

Thank you, Mr. Chairman.

Let me focus specifically upon those issues and points in my study that have been disputed today and yesterday.

It seems to me there are two questions, fundamentally, that arise as to whether TAPS specifically warrants regulation.

One of those questions is that it is necessary to protect consumers in the short run.

Now, what are the facts here and what are really the views? Do the rates being charged by the TAPS carriers, that is, the eight companies that own and operate the TAPS system, do those rates have, at least in the short run, an impact upon consumers of oil, consumers of Alaskan North Slope Oil specifically in the lower 48?

My view is that they do not, and the reason I have advanced is that the oil that moves through the TAPS line goes to the lower 48 areas, is subject to intense and widespread competition from alternative sources, both domestic and foreign, and because of this competition, because of the world and domestic competition to which the TAPS oil is subject, I have reasoned that the prices, the end prices that would be paid by consumers are not influenced by the TAPS shippers, not dictated, not raised to a monopoly level since they cannot be since buyers can turn to an alternative source.

They don't need the oil on the North Slope. They can get it from other places in the United States, or they can get it from abroad. Therefore, I have said in my report that the rates charged by TAPS at least in the short term do not have an impact on U.S. consumers.

I note two supporting positions for this view. First Mr. Maynard speaking and testifying yesterday on behalf of Alaska said on more than one occasion that he saw that even if TAPS rates were reduced rather sharply that there would be no short-term impact upon consumers.

Prices would not fall. I note in the testimony just given by Mr. Blum that he cited Los Angeles and the Los Angeles area as an example of a costal zone or coastal region in which competition is intense, and that is precisely my point.

The competition here from alternative sources is intense, and this, not what TAPS carriers charge, sets the price pattern that is paid by consumers.

You will notice, Mr. Chairman, that I have been speaking here for purposes of responding to the arguments of others, I have been speaking here of the short term. What about the long term?

As I understand it, the State of Alaska has come forth with a theory that says, well, in the long run, if the TAPS carriers' charge is excessive, rates that users view as too high, the result will be to choke off, halt exploration in the North Slope by companies that don't have an ownership in TAPS.

That is the theory they have put forward and was articulated. That argument then is used by them as an assumption, a supposition which says that those rates set too high would choke off exploration and over the long term reduce the volume of oil coming from Alaska, and this will in some fashion for some reason under some set of theoretical model, may have some small impact on consumers over the period of 20 years.

Now, how does that square with the facts?

I don't want to repeat what Mr. Fountain has said, but I do want to note here that the evidence, the facts, the reality of the matter is that on the North Slope many, many oil companies, big ones, small ones, and many of them, without any ownership interest in TAPS, have been committing billions of dollars to explore along the North Slope and in the adjacent seas for oil which they would in all probability have to ship by TAPS.

This was true of lease sale 71 conducted in October of 1982, where companies bid more than $2 billion for 121 tracts, with the Department of the Interior making awards and publicly announcing these to companies such as those mentioned by Mr. Fountain.

Shell, Chevron, Getty, Placid, Murphy Oil and others.

These are companies that have no ownership interest at all in TAPS. Suffice it to say, and I think most would agree that these are experienced companies, have pragmatic management, investing not a few dollars, but literally hundreds of millions of dollars in a number of these cases for the right to explore for oil on the North Slope and now I emphasize, under present conditions knowing present rates being charged by the taxpayers.

Alaska, the State, has alleged and said those rates are too high. They are terribly high. They have been set high, says Alaska, so as to chill, choke off, discourage, to use their word, independent nonowner exploration activity in the North Slope.

Now, with companies of the sort that I have identified, and they go on and on, with those putting in billions of dollars to explore all around regions of the North Slope, under conditions where they know the present TAPS tariffs, I ask is it really realistic to believe that, in light of the tariffs, those kinds of investors taking these kinds of gambles would do so if in fact the rates being charged now were of the height that Alaska believes will choke off investment?

I think there is no respectable factual evidence to support the theory and it can be put no different than that, than a theory; there is no respectable factual evidence to suggest that the rates being charged by the TAPS carriers, which Alaska claims are too high and will discourage investment, there is no evidence to show that they have had that chilling effect.

In fact, to the contrary. Experienced investors not affiliated with TAPS owners, not involved as owners, have committed billions of dollars in order to explore, knowing the present rates.

Now, that is consistent with my view that because the existing sources of oil that move through taps are as estimated by the General Accounting Office, going to begin to deplete later in this decade and be down to something according to GAO by 300,000 barrels like approximately the year 2000, before a line that can carry, as it does at present, 1.6 million barrels per day, that this is all consistent with my view that it is in the interest of the TAPS owners to do as they have been doing.

To set rates that will not discourage investment, but that will encourage investment so that at the minimum they will have a substantial volume of oil to transport in the period in which present sources will begin to be depleted.

I also want to note in concluding that those who talked here about competition have, I think, been again unrealistic in their failure to take account of the various potential oil sources in the Alaskan area in the Arctic that appear to present potential oil deposits of some considerable scale, but that represent alternatives to those who would be served by TAPS.

Again to the extent TAPS rates, if TAPS rates were set so high as to discourage investment in the area near the North Slope, something contrary to fact, as I have said, then investors could go to other areas in the Arctic, seek oil and, if they discovered it, use transportation means, most of them new, but that would be more effective, and that would not involve the use of TAPS.

Again, it seems to me that the TAPS owners are constrained by economic considerations to price reasonably, to price sensibly, not only in their own interest, but in the interest of developing the oil reserves of the Arctic, the North, and thereby compete in a world and U.S. market that is, as I think several of the other witnesses, even those who disagreed with me on a few points, have themselves in one fashion or another agreed are competitive.

So, Mr. Chairman, for these reasons it seems to me that the theories that have been spun here to suggest that TAPS should continue to be regulated are upon fairly close analysis without persuasive merit.

That concludes my comments.

Thank you, Mr. Chairman.

Mr. ANDERSON. Thank you, Mr. Barber, for your statement.

I will direct my questions first to Mr. Fountain, then Mr. Barber. Then I will recognize Mr. Shuster.

Mr. Fountain, other witnesses have told the subcommittee that intermodal competition with TAPS is not feasible. Moreover, statements were made by those witnesses that indicate that it is extremely unlikely that another pipeline will be constructed in Alaska.

Do you agree with those statements?

Mr. FOUNTAIN. Well, we can, you know, we can quibble over words. I think certainly other alternative means are feasible.

I don't know of anybody that is currently preparing to go up there and build another one. In fact, before we built TAPS, there were competing pipelines considered through the McKenzie Valley, through Canada and there have been several considerations for using icebreaking tankers to go around to the North Slope.

But, no, I don't know of any current serious project to build a competing mode to TAPS. No. Again, you have to understand, and I don't want to be pedantic about it, that as an undivided interest pipeline company, each of the eight owners in TAPS owns a certain piece of that facility.

Now, Alyeska, as such, is simply an operating company. They turn valves, they run pumps, whatever. We, as Exxon Pipeline Co., every month are told by that operator that this month we can ship so much through that pipeline, and our share is so much, and we go out and solicit that business at our filed tariff and we invoice for that oil. We handle it just as if we had a separate pipeline laid up there on that ground. It is in one hole for the economies of scale and probably the political realities to get a permit to build it up there, but each of these companies operates as a separate company in that space.

Mr. ANDERSON. We heard several times the remark that Alaskan Pipeline, the money was paid back in 3 years. You got your investment back in 3 years.

Another place we heard them saying you were making a 100 percent on your investment. Are either of those in the ball park?

Mr. FOUNTAIN. No, sir. I am so glad you asked that because that was one of the other things in my pile I forgot to bring up in my direct remarks.

Mr. ANDERSON. I think the last I heard you got it back in three years. The second was 100 percent a year.

What is it, approximately? Not that we are opposed to your making money.

Mr. FOUNTAIN. I understand that and I am not opposed to it either, but I would like to get accused of only making as much as we are really making.

Let me tell you where I think it is coming from because I am not sure that we are—I think we are taking numbers and doing strange things with them. If I understand where that statement came from, someone calculated and said that the tariff charged, you know, the barrels that go through it, you can multiply say $6 a barrel by all those barrels; it will come up to maybe $3 billion a year revenue. So it cost $9 billion to build it. Therefore, if you are getting $3 billion a year revenue, you have paid for it in 3 years.

But I really didn't think anyone would seriously conclude that we have paid for that pipeline in 3 years.

Unfortunately, out of the money we collect, we have to operate it; we have to pay for our interest on our bonds; we have to do all these routine things, so that the net incomes are nowhere near the total revenues as anybody who had taken Economics 101 knows.

In fact, I will be specific.

If you take Exxon pipeline's net earnings for 1982 as representative of the whole pipeline, as I said, there are eight in there; we are all different, we are all financed differently and what-have-you.

But, if you take that against the roughly $9 billion dollar or our share of a $9 billion dollar original investment, I think you will come up with about 7 years that it would take to pay that out on net income.

That is really not the way economists figure payout, but that is an approximation.

Now, that is 7 years from the date the pipeline went into operation. You have to appreciate that this project got started in 1968, which is 10 years before it ever went into operation, and significant investments, in the hundreds of millions, started in 1974. So, in my mind a more representative payout number is something like 7 years after initiation of operation or 10 years from the first commitment of funds.

I don't know if Mr. Barber might want to add something to that. He is an economist. I am just a lawyer.

Mr. **Barber**. The companies put the number in different respects, but Exxon's calculations, and those are reflected in, I believe, the letter that Mr. Fountain is going to submit for the record, put the number at around 15 percent, which would suggest a payout of something like 7 years.

Mr. **Anderson**. Information furnished to the subcommittee indicates that the industry's operating revenues for 1981 were $6.6 billion. What were the operating revenues of TAPS, and are those revenues included in the $6.6 billion?

Mr. **Fountain**. I can't answer that.

Mr. **Anderson**. Could you get that for the record for us?

Mr. **Fountain**. Yes.

[The question posed by Representative Anderson and response from Mr. Fountain follow:]

Question [Mr. Anderson]. Information has been provided to the subcommittee that the oil pipeline industry operating revenues for 1981 were $6.6 billion. What are the operating revenues of the eight TAPS owners and is it included in the $6.6 billion figure?

Answer [Mr. Fountain]. The August 1981 issue of Pipeline and Gas Journal at pages 42 to 46 reflects that operating revenue of the top 100 operating revenue for the TAPS owners is $3.7 billion. However, the operating revenues for Exxon, Sohio, and ARCO also include lower 48 operations. Exxon Pipeline Co.'s operating revenues from TAPS for 1981 were $695,997,000. Exxon Pipeline does not have information on Sohio and ARCO to determine their TAPS operating revenues.

Mr. **Anderson**. We would like to be able to put some of these figures together.

Mr. **Fountain**. I will be happy to get them for you. I just can't answer because I don't know.

Mr. **Anderson**. We will submit the question to you so you can get it back.

Mr. **Fountain**. What year are you talking about, sir?

Mr. **Anderson**. 1981. Information furnished to the subcommittee indicated, indicates that the industry's operating revenue for 1981 was $6.6 billion.

What were the operating revenues of TAPS, and are those revenues included in the $6.6 billion?

Mr. **Fountain**. We will get that for you. I just don't know, sir.

Mr. **Anderson**. Yesterday Robert Maynard, assistant attorney general for the State of Alaska, testified. This was his statement: The ability of TAPS owners to use TAPS to shelter oil, shelter in quotes, shelter oil income from the windfall profits tax and the State severance tax and royalty obligations has been the subject of several congressional, IRS, and State hearings. Deregulating TAPS would give near total discretion to the others to shift revenues away from their tax liable producing affiliates to their pipeline subsidiaries.

Do you agree with that statement and please explain why you agree or disagree.

Mr. **Fountain**. I am not sure I know enough personally to agree or disagree. I have heard what was said about the windfall profits tax. I know a little bit about how it works.

But we can—turn it around the other way, Mr. Chairman. If the TAPS tariff were zero, there would be a lot more money, so you can play all kinds of games with what the tariff is.

As I said earlier in my remarks, this committee is going to have to do a balancing act, I think, as to what they really want to achieve with pipeline deregulation.

If you want to achieve the incentive for the development of frontier pipelines like TAPS, then deregulation is something that should be considered.

You know, again, you are never—you are always going to have somebody that is going to—any time money goes from A to B, whoever is in A is not going to like it because it is going to B, and I think the thing that you have to look at on the TAPS revenues is, are those revenues adequate to compensate the investors who were willing to put that $9 billion up there with no one guaranteeing they were going to get it out.

Now, if they were more than adequate, that is another problem. I don't personally believe so. Mr. Barber might want to add to that because of the constraints that he sees that those tariffs will remain reasonable, and if they are reasonable, whether or not they interfere with tax collecting I think is really kind of a bogus issue.

Mr. BARBER. Mr. Chairman, I believe that each of the companies, I am sure each of the companies believes that the way it is handled, the very complex tax matters, is consistent with existing law and procedures.

The IRS and Treasury Department certainly have indicated they have no compunction to disagree with the oil companies, if they feel so inclined.

Certainly Treasury and the Internal Revenue Service do not appear to concede that the companies have complete, unbridled freedom to manipulate bookings or charges as they wish. So, given all of that, it seems to me that what we are involved with here is an enormously complex matter of taxes and tax administration that really is not fundamentally related to the issue of regulation or deregulation which I think should be looked upon on its own.

And, as Mr. Maynard acknowledged yesterday and as I believe is the case, however one handles these bookkeeping transactions, whether it comes to the impact on the consumer in the lower 48, there is no short-term effect, and I think that is a proper major focus of concern on this occasion.

Mr. ANDERSON. I have a series of questions here that kind of give us a composite of TAPS so we will know a little bit of what we are talking about. What was the cost of TAPS?

Mr. FOUNTAIN. Approximately $9 billion.

Mr. ANDERSON. Either of you can answer.

Mr. BARBER. $9 billion.

Mr. ANDERSON. At current rates how long will it take its owners to pay for it?

Mr. FOUNTAIN. Well, let me—if you took all of the net income and applied it to pay for it, in other words, you made no return on your money, I have already given you a number.

You know, 7 years from initiation of operations, or 10 years from the time the major investment started, in any way of thinking the way you pay for something is, you depreciate it out; you take so much to get your money back through depreciation each year.

On the basis of the stipulation we have made in the rate case, we have a 35-year depreciation schedule for TAPS.

So the capital will be recovered——

Mr. ANDERSON. Thirty years?

Mr. FOUNTAIN. Thirty-five years.

Mr. ANDERSON. Thirty-five years?

Mr. FOUNTAIN. That is an agreed stipulation with all the parties in the rate case.

Mr. ANDERSON. Do you know how profitable the line has been to its owners?

Mr. FOUNTAIN. Well, based on what measure, sir?

Mr. ANDERSON. Well, I mean you make—I mean you say you can't tell how, what the cost was or how long it would take to pay for it because you have to give them some income.

You give them whatever you want to give them.

Mr. FOUNTAIN. Fine.

Mr. ANDERSON. Then obviouly these things all fit together. If you are paying off dividends, it is going to take a little longer and so on.

Then my next question was, kind of along the same line, how much would it cost to duplicate TAPS in terms of 1983 dollars?

Now we are getting to depreciation, where at the same time you have probably got some appreciation in there, and also some inflation.

Mr. FOUNTAIN. Well, I am not sure—let me answer your first question first.

Mr. ANDERSON. I think maybe what I will do is submit these four questions to you and have you give us an answer looking at them in that line.

Obviously we know you built it with cheaper dollars, better dollars, and we have had inflation since.

In the meantime, you have had dividends, at the same time you have been paying it off, and I think we ought to know where we have been and also what it would cost to duplicate it in terms of today's money.

Mr. FOUNTAIN. If you will permit me to respond to that, I will submit it for the record.

Mr. ANDERSON. Yes.

[The questions posed by Representative Anderson and responses received from Mr. Fountain follow:]

Question [Mr. Anderson]. What was the costs of TAPS?

Answer [Mr. Fountain]. The total cost of TAPS at year-end 1982 was \$9.4 billion. Exxon Pipeline Co.'s share of that cost was \$1.84 billion.

Question [Mr. Anderson]. How much would it cost to duplicate TAPS?

Answer [Mr. Fountain]. The replacement cost of the original TAPS investment, in 1982 dollars, utilizing the oil pipeline cost indices developed annually by FERC would approximately \$13.7 billion. Exxon Pipeline Co.'s approximately 20 percent share of that cost would be \$2.8 billion.

Question [Mr. Anderson]. What is the return on cost of duplicating TAPS?

Answer [Mr. Fountain]. Based on the cost of reproduction new of TAPS developed by utilizing the FERC oil pipeline cost indices described in the preceding answer, Exxon Pipeline's delivered return on the cost of duplicating TAPS would have averaged 9.36 percent for the years 1980–82. "Delivered returns" measure the economic efficiency of total capital employed, debt and equity. They represent the return on capital adjusted for the after-tax debt related interest expense. This measure removes the effect of debt financings. This calculation is set out in the table below.

AVERAGE RETURN ON TAPS REPRODUCTION COST NEW

[Thousands of dollars]

	Operating net income	After tax interest expense	Delivered net income	Reproduction cost new	Delivered return on reproduction cost new (percent)
1980	197,996	54,834	252,830	2,324,464	10.88
1981	196,860	48,714	245,574	2,576,917	9.53
1982	170,366	49.169	219,535	2,768,441	7.93
Total	565,222	152,717	717,939	7,669,822	9.36

Question [Mr. Anderson]. At current rates, how long will it take TAPS owners to pay for it?

Answer [Mr. Fountain]. In answer to this question, I refer the members of the subcommittee to a letter of July 29, 1983, by Mr. L. D. Wooddy, Jr., president of Exxon Pipeline Co., to Chairman Rostenkowski of the House Ways and Means Committee, in which Mr. Wooddy said: "Based on an initial investment by Exxon Pipeline in TAPS of approximately $1.8 billion and considering 1982 net cash flow as representative, it would take more than 7 years for net cash flow to equal the original TAPS investment."

I attach a copy of Mr. Wooddy's letter and ask that it be included in the record of these hearings.

Exxon Pipeline Co.,
Houston, Tex., July 29, 1983.

Hon. Dan Rostenkowski,
Chairman, Committee on Ways and Means,
Washington, D.C.

Dear Congressman Rostenkowski: We wish to address the topic of profitability of the Trans Alaska Pipeline System [TAPS] which was one of the items discussed during the hearing on revenue increase proposals before your committee on July 21, 1983.

Exxon Pipeline Co. is one of the eight TAPS owner companies with an interest of approximately 20 percent. Each owner company operates its share of the pipeline as a separate common carrier. While each owner company's financial results will vary, Exxon Pipeline Co.'s operating results should be similar to that of other owners and representative of overall TAPS financial experience.

Based on an initial investment by Exxon Pipeline in TAPS of approximately $1.8 billion and considering 1982 net cash flow as representative, it would take more than 7 years for net cash flow to equal the original TAPS investment.

I hope this information will be helpful to your committee and enhance understanding of TAPS investment and profitability.

Yours very truly,

L. D. Wooddy.

Mr. Fountain. If someone is taking notes as to what I am supposed——

Mr. Anderson. We will give you a copy of the questions.

Mr. Fountain. Fine.

Mr. Anderson. My last question is, according to the State of Alaska, TAPS is charging a composite rate of $6.20 per barrel of oil. If H.R. 2677 were enacted, what effect would it have on that rate?

Mr. Fountain. I don't think it is going to be the end of the world. I really don't think it would have any effect.

Mr. Anderson. You don't think there would be any change then to the composite rate of $6.20 per barrel of oil?

Mr. FOUNTAIN. I have no reason to think it would.

Mr. HUNTER. I thought I didn't have any questions, Mr. Chairman, until this last response.

You are saying that, Mr. Fountain, this legislation, if it is passed, the cost to move a barrel of oil, your price, your composite price will not change?

Mr. FOUNTAIN. I don't know of any reason why it should change. I am only one operator in that pipeline. I don't know any reason it should change. I don't anticipate anybody is going to be raising their tariff. I don't know that.

Mr. HUNTER. You would be free to respond to market forces?

Mr. FOUNTAIN. That is right. I should—I don't think if it is effective on the first of January, that on the second of January there is going to be change. I don't think that.

I think certainly if TAPS is deregulated that the operators of TAPS will be free to exercise their business judgment to run their businesses, and reflect the market as it occurs.

Currently I would think with the oil market being what it is there would be any no reason why that market would change significantly; there would not be any reason to change——

Mr. HUNTER. In the long run, what would the effect—I had the impression that the industry was arguing that deregulation in the long run would change market forces favorably.

Mr. FOUNTAIN. They most probably would.

Like I say, I don't—TAPS, right now, is running chock-a-block full. It is taking every barrel that is available for shipment and moving it to Valdez.

Now, that situation is not going to change in the next few months, or several years.

Now, certainly, when times change, there is going to be a different market situation and each of the carriers is going to have to look at that market situation and reflect it in how it runs its business.

Certainly with deregulation the—you get to do it as an entrepreneur rather than seeking some change from a regulator.

Mr. HUNTER. Yet if you are running at 100 percent of capacity, you certainly—nothing is motivating you to reduce your price.

Mr. FOUNTAIN. Other than the fact that when people look at where you are going to be a few years from now, and you are not going to be 100 percent of capacity if somebody else doesn't find any oil up there, then you don't want to be pricing yourselves at a point that you discourage somebody from finding something that you can ship through that pipeline.

That is why I think that the people who are buying leases on the slope now are doing so with the confidence that they are going to be able to transport the oil that they find off that slope at a reasonable price, because they know that we are equally concerned that we are going to have the oil to transport.

Mr. HUNTER. You have a common carrier obligation.

Mr. FOUNTAIN. Yes, sir.

Mr. HUNTER. Which means if oil is presented to you, you have to prorate it.

Mr. FOUNTAIN. Yes, sir.

Mr. HUNTER. And where one owns, Exxon owns 20 percent, if Exxon owns 20 percent and somebody owns nothing, nevertheless, as all of this is presented to you to be carried, you must apportion it based—

Mr. FOUNTAIN. Yes, sir, and we have been doing that for some time.

In fact, quite frankly the idea that we are somehow matched and that Exxon pipeline carries all of Exxon's oil is a fallacy. We carry about 20 percent of Exxon's oil. Oil is tendered to us and we take it until we fill up and we prorate it out.

Mr. HUNTER. You have the same obligation, of course, in a deregulated environment as well?

Mr. FOUNTAIN. As this bill is drafted, yes, sir.

Mr. HUNTER. Thank you, Mr. Chairman.

Mr. ANDERSON. How long will the present field last?

Mr. FOUNTAIN. Well, that is a matter of—you would have to have a composite—

Mr. ANDERSON. You must have some idea though, don't you?

The reason I am asking, I know I was one of the very, very strong advocates of the Sohio pipeline from Los Angeles/Long Beach to Midland, Tex. We were told if we were to build it at a particular time it would be economic because the field capacity would be there to sustain it.

Mr. FOUNTAIN. Right.

Mr. ANDERSON. We were told because so much time was wasted, everything that held us up, it eventually became so that it is not now economic to do it.

Mr. FOUNTAIN. Right.

Mr. ANDERSON. Which implies to me, or tells me that somebody knows something, that there isn't enough oil up there down the road to put that kind of investment in the field.

Yet when I hear about all these people who want to come in there and drill, it gives me the question there maybe is some more oil up there that you people will be getting.

Mr. FOUNTAIN. If I understand what your question is, Mr. Chairman, of the known existing reserves that we are now transporting, I think this decade, toward the end of the eighties, those reservoirs are going to start depleting. Now, there are other reservoirs up there that have already been discovered, and they are trying to figure out how to develop them and, if those, some of those, come on and how they come on will determine whether or not the pipeline has sufficient throughput to be full, or, you know, what the throughput actually is, depending on as these fields come on and as they are connected.

I am so happy you asked that question. There is something else I forgot to mention, concerning frontier pipelines and this idea that every frontier pipeline is going to be regulated like an electric utility.

You know somebody sitting out there at Duck Island, or Milne Point or offshore on Prudhoe Bay thinking about putting some millions or billions of dollars in a pipeline to connect up with TAPS, has to be wondering if he is going to get his money back.

You know, you have some tremendous technological problems. You have some expensive construction. Those are the frontier pipelines that we are talking about that this Congress needs to be concerned about as a policy matter, if you want to encourage investors to pony up the money to build these pipelines.

On TAPS, we have pump station No. 1 in the Prudhoe Bay field. When the Kuparuk pipeline production came on, Kuparuk Pipeline Co. a completely separate organization, built the pipeline into TAPS. Like TAPS, they have a rate case pending over in FERC now where those people are wondering what they are going to earn on their investment.

I don't know anything about it, other than they are there, because my company doesn't have any interest in it. But I hope I have been responsive to your question.

Mr. ANDERSON. I think so.

Well, thank you very much, Mr. Fountain, Mr. Barber, for your presentations.

This concludes our hearings then. Thank you very, very much. The subcommittee stands adjourned.

[Whereupon, at 3:21 p.m., the subcommittee adjourned.]

ADDITIONS TO THE RECORD

The Heritage Foundation
A tax-exempt public policy research institute

September 28, 1983

The Honorable Glenn M. Anderson
Chairman
House Subcommittee on Surface Transportation
2165 Rayburn
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed is a Backgrounder by Policy Analyst Milt Copulos on "Natural Gas Deregulation: Giving the Consumer a Choice."

Would you please insert it as part of the written record on oil pipeline regulation?

Please give me a call if you have any questions.

Sincerely,

Virginia E. Gilbert

Virginia E. Gilbert
Director, Legislative Information

VEG:djw
enclosure

Edwin J. Feulner, Jr., *President*
Burton Yale Pines, *Vice President*
Phil N. Truluck, *Executive Vice President*
Richard N. Holwill, *Vice President*
Willa Ann Johnson, *Senior Vice President*
John A. Von Kannon, *Treasurer*

Board of Trustees

Hon. Frank Shakespeare, *Chairman*
David R. Brown, M.D.
Joseph Coors
Midge Decter
Hon. Jack Eckerd
Edwin J. Feulner, Jr.
Joseph R. Keys
Hon. Shelby Cullom Davis, *Vice Chairman*
Robert H. Krieble, Ph.D.
J. Frederic Rench
Hon. William E. Simon

513 C Street, N.E. • Washington, D.C. 20002 • (202) 546-4400

The Heritage Foundation Backgrounder

No. 250 The Heritage Foundation • 513 C Street • N.E. • Washington, D.C. • 20002 • (202) 546-4400

March 1, 1983

NATURAL GAS DEREGULATION: GIVING THE CONSUMER A CHOICE

INTRODUCTION

This winter's unprecedented natural gas price rise--as much as 60 percent in some cases--demonstrates dramatically that the Natural Gas Policy Act (NGPA) fails to protect the consumer. Enacted in 1978, the NGPA was intended to restore some semblance of a free market in natural gas, while at the same time protecting the consumer from sudden, sharp price hikes. Yet, these very NGPA regulations, designed to shield the gas consumer from high prices, are responsible for the current increase. Worse still, should Congress to extend the rules beyond their 1985 expiration date, as nearly happened in last autumn's lame duck session, gas consumers could wind up paying as much as $153.7 billion more for natural gas over the next six years than they would if controls were lifted. For the average homeowner, this would mean an additional $887.80. And every consumer would see spurts in the price of a host of gas-dependent commodities, such as food and plastics.

Rather than eliminating market distortions, the NGPA has magnified them. It made natural gas regulations more complex instead of simplifying them, and it extended their scope far beyond previous regulation. It promoted investment in the highest cost sources of gas at the expense of low and moderately priced supplies. Most important, it reduced, rather than enhanced, the power of gas consumers to influence the operation of the gas market.

The Natural Gas Policy Act is fatally flawed. But the reasons for its failure go beyond the circumstances that surrounded its enactment. Just as the price hikes and market distortions of today are the natural consequence of the NGPA's regulations, the NGPA was an unfortunate reaction to a long series of events

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

that preceded its enactment. In a sense, the billions of dollars of added consumer costs, and the potential shortages that loom large on the natural gas horizon, are the culmination of policies initiated 45 years ago.

The current debate over natural gas regulation offers an opportunity to correct the mistakes of the past. All Congress need do is take a few steps to restore the consumer's power to influence the natural gas market. These include:

* Declaration of a "renegotiation period" for all existing domestic natural gas contracts, during which "take or pay," "most favored nation," and "indefinite price escalator" clauses will be null and void.

* Elimination of impediments to direct negotiations between producers and consumers by classifying natural gas pipelines as "limited common carriers."

* Establishment of a date for re-evaluation of all natural gas import licenses. During the period leading up to the re-evaluation, foreign gas producers would be encouraged to renegotiate the prices in their gas contracts.

* Elimination of all price controls on natural gas.

These steps again will make consumers sovereign in the natural gas market. Without these steps, consumers will suffer the shortages, higher prices and economic dislocations that are regulation's inevitable legacy.

THE EARLY HISTORY OF NATURAL GAS REGULATION

In its early days, the natural gas market was free of federal interference. In the 1920s, however, widespread pipeline mergers gave rise to fears that the gas industry was becoming too concentrated. Alarmed, the Senate charged the Federal Trade Commission (FTC) in 1929 with examining the status of the natural gas market. A 1935 FTC report concluded that the Senate's fears were justified and that excessive concentration was leading to cut-throat competition, which in turn threatened to squeeze out small gas producers.

The legislators responded with the Natural Gas Act of 1938. It extended the jurisdiction of the Federal Power Commission (FPC) to include some aspects of the natural gas market. The most important of the Commission's new powers was the regulation of the rates charged by interstate gas pipelines. In broadening the FPC's authority, however, the Act specifically excluded "the production or gathering of natural gas." It remained for the Supreme Court, in its 1954 landmark Phillips v. Wisconsin decision, to bring wellhead prices of interstate gas fully under FPC control.

Phillips effectively established a dual market for natural gas. The intrastate market, consisting of gas produced and sold within a single state, was kept free of federal interference. But the interstate market, covering gas that moves between states, was made subject to federal controls.

It was soon evident that the Court had given the Commission an unmanageable task. The FPC tried to regulate wellhead gas prices the same way it would regulate a pipeline or electric utility. But ratemaking of that kind proved ill-suited to the circumstances under which gas is bought and sold. Unlike pipelines or electric power plants, there is no uniformity or predictability in the costs incurred in drilling gas wells--even within the same geologic basin. Moreover, no allowance is made under conventional utility ratemaking procedures for the capital formation needed for exploration. Most important, there are many more firms involved in gas production than there are electric utilities or pipelines. As a result, the FPC attempt to treat wells on an individual basis generated an avalanche of paperwork. By 1960, a backlog of 3,278 cases had developed.

To simplify the process, the FPC adopted "area wide rates" for specific geographic regions. Within each region, all producers were subject to the same price ceilings, regardless of their individual costs. The trouble with the approach was that it became virtually impossible to raise prices for any producer, no matter how justified, because to raise them for one meant raising them for all. This was because in the event of a general price increase, producers with lower production costs might receive a windfall--something the Commissioners, who saw their job as keeping gas prices as low as possible, were loath to condone. The result was a de facto price freeze on interstate gas rates through most of the 1960s. The effect of the freeze was to discourage the development of new gas supplies and encourage excess gas consumption.

Over time, this led to a steep decline in gas reserves earmarked for the interstate market. The ratio of such reserves to production plummeted from 18.9 in 1964 to 8.5 in 1977. Proved reserves dedicated to the interstate market dropped from 189 Trillion Cubic Feet (Tcf) in 1967 to 92 Tcf in 1977.

In the intrastate market, however, reserve levels increased slightly from 92 TCF to 115 Tcf during the same period. This took place with prices only modestly higher than those prevailing on the interstate market. Increasingly, pipelines found it necessary to curtail service to industrial and commercial customers in order to meet residential demand. By 1970, these curtailments amounted to one billion cubic feet. A crisis was rapidly developing.

THE NATURAL GAS POLICY ACT OF 1978

The winter of 1976-1977 proved a turning point in the natural gas debate. Record low temperatures plagued large sections of the gas-consuming states in the northeast, causing demand for gas to skyrocket. Severe shortfalls of gas soon developed, leading to widespread factory closings and the imposition of a host of emergency conservation measures. To avert even more drastic economic disruptions, Congress passed the Emergency Energy Natural Gas Act. This suspended some price restrictions to permit the transfer of gas from intrastate supplies to interstate pipelines. Although the move solved the immediate problem, it skirted the basic issue: that the shortage had been caused by market distortions arising from federal price controls. Congress tried to address that in the Natural Gas Policy Act of 1978.

In spite of the harsh lessons of the winter of 1976-1977, Congress was still reluctant to face squarely the issue of gas price controls. Many Members feared that removal of the federal ceilings would lead to sharp gas price increases just as they were entering an election year. Others felt that gas supplies were nearing exhaustion, and that removing controls would somehow result in an unwarranted windfall to gas producers. Still others opposed decontrol out of a deep-seated hostility toward the oil and gas industry.

An Ad Hoc Committee on Energy was convened to resolve the matter. After nearly a year and a half of sometimes acrimonious debate, the Committee agreed on a proposal acceptable to Congress. In September 1978, the Natural Gas Policy Act was signed into law.

Although touted as a "decontrol" measure, the NGPA was nothing of the sort. As a trade-off for the eventual lifting of federal price ceilings on between 50 and 60 percent of natural gas supplies, the intrastate market, previously free of federal interference, was brought under the FPC's authority. Worse, it drastically increased the complexity of natural gas regulation by creating eight primary categories and thirty subcategories into which gas wells were classified.

It was the intent of the NGPA to allow prices for "new" natural gas to rise gradually to a level equal to the world price for an equivalent amount of crude oil. The phase-in of market prices was tied to an estimate of what the world price of oil would be in 1985--the year in which most NGPA controls expire. But the Act stipulated that gas from existing wells, called "old" gas, would continue to be subject to federal price ceilings. Also, certain types of gas wells, defined as "high-cost" gas in Section 107 of the Act, were decontrolled immediately. The NGPA thus set into place a series of market distortions that contained the seeds of the current price increases.

THE NGPA'S DEFICIENCIES

Like other congressional attempts at regulating natural gas prices, the NGPA suffers from inherent flaws.

Price Dislocation

Among the most serious flaws is the linkage of price increases permitted under the Act to a fixed "target" price for oil, based on a forecast of the market in 1985. This allowed no flexibility for orderly responses to shifting circumstances in the world market. In the year following enactment of the NGPA, for example, the world price of gas rose 48 percent, while U.S. domestic prices increased only 11.6 percent. As a result, the gap between the U.S. and the market price grew, increasing the possibility of a sharp price rise when controls finally expire--exactly the situation the Act was supposed to avoid.

Perverse Incentives

Another problem arose from the system of categories devised under NGPA. Under the Act, "old" gas (from wells drilled before April 1977) is to remain under federal control after 1985 and prices can only be increased at the pace of inflation. At the same time, producers of "high-cost" gas, under Section 107, can charge whatever the market will bear. Pipeline companies with large amounts of "old" gas under contract can use its low prices as a "cushion" against the higher prices they pay for Section 107 gas, by averaging the prices. Moreover, federal regulations that allow pipelines to pass the full cost of gas purchases on to their customers, and require that they maintain certain reserve levels, have led them to be far more concerned with continuity of supply than with price. Therefore, there has been little incentive for a pipeline to obtain gas supplies at the lowest possible price.

For gas producers, the NGPA categories created a tremendous incentive to search for gas in the highest cost categories. The prices allowed for other types of gas wells, meanwhile, often were insufficient to justify the investment drilling an exploratory well entailed. As a result, there was a severe misallocation of resources.

More and more, pipelines began contracting for high-cost gas to replace dwindling "old" gas reserves. Also, the low federal price ceilings imposed on "old" gas, and gas from existing reservoirs, made it less and less economic to develop and market these supplies. At the same time, the prices for equipment and materials for oil and gas drilling were dramatically increasing--as high as 400 percent for some items. In many cases, gas simply could not be sold profitably at the "old" gas price. By 1981, according to the Energy Information Agency, 70 percent of new gas purchases by pipelines were accounted for by high-cost gas, even though there was a surplus of available lower cost gas equal to between 15 and 20 percent of the total gas demand.

Gas imports were ignored under NGPA. Yet imported gas from Mexico and Canada and liquified natural gas (LNG) from Algeria play an increasingly important role in the U.S. picture. In 1981, consumers paid an extra $4.2 billion for imported gas; in 1982 the cost may be even greater.

Contracting Practices

With increasing frequency, pipeline companies are entering into "take or pay" contracts for extremely expensive sources of gas. Under these contracts, the pipeline agrees to pay a producer for a specified amount of gas whether or not it accepts delivery. The practice of entering into such contracts arose out of necessity. Exploration and development of natural gas is capital intensive and highly risky. To justify their investment, producers sought to ensure at least a minimum return. As such they required pipelines to agree to a "take or pay" clause, to protect themselves from a sudden loss of their market. In most cases, the pipelines also insisted on what is called a "market out" clause, which permitted them to withdraw from the agreement if prices were too high.

After enactment of the NGPA, though, a new type of "take or pay" contract came onto the scene. Pipelines with large "cushions" of old gas began entering into highly restrictive "take or pay" contracts for gas produced under Section 107 (i.e. high-cost gas) of the NGPA, and for gas from foreign suppliers. Often, these contracts imposed "minimum take" requirements (the amount that must be either accepted or paid for) which were far higher than the customary level in years past. More important, many of these contracts had no "market out" provision. As a result, the pipelines were locked into using the gas contracted for regardless of the price. In many cases, this meant that the pipeline was accepting higher cost gas at the expense of lower cost supplies that were available. For example, Columbia Pipeline, which serves areas of the northeast, including Baltimore and the Washington, D.C. metropolitan area, filed a request for rate increases totalling nearly $1.5 billion to pay for such gas purchases, even though other suppliers were willing to sell the company gas at a fraction of what they were paying for the high-cost gas. Unable to convince Columbia to do business, the producers ended up shutting in, and in some instances even flaring (burning off into the atmosphere), their gas instead.

THE CONSUMER IMPACT OF CONTINUING CONTROLS

It is now clear that the price controls established under the Natural Gas Policy Act have failed to keep gas prices down. In Virginia and West Virginia, they have risen 25 percent in the last year alone. In Pennsylvania, increases ranged from 21 to 28 percent. In Dallas, and some parts of Missouri, a staggering 60 percent price hike occurred, and in Southern California gas prices jumped 35 percent over the last twelve months.

Paradoxically, the failure of NGPA controls has led some Members of Congress to call for their extension. Mistakenly believing that the nature of the price ceilings, rather than the fact that price ceilings were imposed is to blame for the increases, they are pressuring the Administration to exercise its authority under Section 122 of the NGPA, and extend the phase-out of controls through 1989. Taking this course of action would be a drastic mistake. Not only would extending controls fail to keep gas prices down, it would actually result in far higher prices than if the market were allowed to operate. Just how much higher prices would go under controls can be demonstrated using a model of the oil and gas market developed by Dr. Helmut A. Merklein of Texas A&M University.

Applying the Merklein Model

In his model of the natural gas market, Dr. Merklein devised eight scenarios which predicted the supply and demand responses of natural gas to a variety of decontrol schemes. These ranged from an extension of NGPA controls, as desired by some Members of Congress, to one in which all controls are immediately lifted.

Assuming that controls were to be phased out gradually over a six-year period including the years 1983 to 1988, with full decontrol following in 1989, the model predicts varying shortages of conventional gas. This shortfall would have to made up from other, unconventional sources, such as Section 107 gas, imported, or liquefied natural gas. Some might also be made up by switching to an oil product such as residual fuel oil, or #2 fuel oil. In virtually every case, however, the alternative would be more expensive than conventional natural gas. The shortfall, it should be emphasized, would not be the result of a lack of supply, but rather the lack of incentives fostered by NGPA price ceilings. Over the period between 1983 and 1988, the cumulative shortfall projected by the Merklein model comes to 206 Tcf. This is the amount of gas that would have come from high-cost sources. The question is, at what price?

Should current contract trends continue, it may be assumed that most of the shortfall will be covered by purchases of Section 107 gas, mostly from deep wells. Although there has been a decline in Section 107 prices recently, due to the fall in gas demand accompanying the general economic slowdown, a resurgence of economic activity can be expected to witness a corresponding strengthening of deep gas prices. Under these circumstances (even assuming that all other costs remain constant), the cumulative cost to the consumer would be $153.7 billion more over the six years than if all controls were immediately removed. This would mean a $32.8 billion, or 24 percent, rise in the nation's natural gas bill in the first year alone. For the average homeowner, the extra cost over the full six years would be $877.80. If the effect of higher gas prices on commodities such as fertilizer, plastics, and other petrochemicals is taken into account, the full cost of higher gas prices for a family of four would equal nearly $4,160 for the six years, and nearly $900 in the first year. These figures, of course, assume that price controls are gradually phased out. Should they be extended, the results could be even worse.

RESTORING CONSUMER SOVEREIGNTY

It is evident that controls not only are not working, but are contributing to natural gas price rises. The question then becomes: what should be done? The answer: restore consumer sovereignty to the natural gas market.

The notion of consumer sovereignty holds that consumers should have the widest possible latitude in making economic choices. If this is not the case, then willing sellers and willing buyers cannot transact freely, a free market cannot exist, and there will be costly misallocations.

In the natural gas market, government at the state and local level has imposed a third party--the pipelines--between gas producers and gas consumers. Although the stated function of the pipeline is to transport natural gas from its point of production to the point of local distribution, pipelines effectively have become the wholesalers of natural gas in the years following enactment of the Natural Gas Act. As regulated monopolies with exclusive service areas, their revenues are at best only indirectly linked to the cost of the natural gas they contract for. In most cases, moreover, they are able to pass through the full cost of gas purchases to the consumer. As a result, and unlike the ultimate user of the gas, they have little incentive to keep those costs down. So the consumer's normal inclination to bargain for the lowest price is frustrated by the imposition of a middleman between him and the producer.

For gas producers, the situation is no better. Because they contract with pipelines which are regulated monopolies, rather than the ultimate consumer, their market alternatives are also limited. The pipeline not only determines the price a producer receives, but how much he can sell as well. The result of these circumstances has been to create a range of natural gas prices running from as low as 25 cents per thousand cubic feet (mcf) to as high as $11 per mcf--all for the identical commodity. In a free market, this situation would not exist.

In a free market the price of natural gas would be determined by the value consumers placed on it. Some feeling for how the market might operate can be gained from the recent experience of eliminating federal price ceilings on crude oil and refined products. Rather than leading to a rapid and sharp rise in oil prices, quite the opposite occurred. In fact, the U.S. composite price for crude oil (the average of what refiners pay for imports and domestic supplies) is now 14.3 percent lower than it was at its peak in March of 1981, a month after controls were lifted.

With the elimination of federal controls on oil, consumers could express their market preference and force the price down. Under the current structure of the natural gas market this cannot occur, or at least cannot occur as easily, because the consumer's sovereignty is severely limited by NGPA regulations. To remedy this situation, and restore consumer sovereignty, a number of steps must be taken.

HOW TO RESTORE CONSUMER SOVEREIGNTY

The first step in restoring consumer sovereignty is to eliminate the gas pipeline as a middleman to the extent possible. In some cases, gas users may prefer pipelines to act as a broker. In most cases, however, local distributors will want to enter into their own agreements with producers.

To accomplish this, however, certain aspects of existing gas contracts must be revised, particularly those which would be triggered automatically and lead to higher prices if controls were lifted. Gas experts refer to this phenomenon as "the contract problem."

This problem can be resolved by establishing a period during which the questionable clauses would be renegotiated. A period of adjustment also is needed if the transition to a free market is to take place.

During the "renegotiation period," both producers and pipelines would have the opportunity to "market out"--to abrogate their existing agreement. This would free pipelines from the "take or pay" requirements, and would allow producers to find other customers. During this period gas distributors, together with large industrial customers, would be allowed to contract directly with producers.

To the extent that direct contracts take place, the pipelines would, become a sort of limited common carrier, in the same way oil pipelines are. Their obligation would only be to transport, not supply gas.

The question of foreign supplies could also be dealt with during this period. As suggested by Representative Tom Corcoran (R-Ill.), Congress could require that by a specified date, say six months after enactment of the legislation, the Secretary of Energy must review all import licenses for natural gas and determine whether to allow them to continue. The basis of his decision would be the price and would force renegotiation of prices above market levels. Some governments, especially Canada's, currently refuse to allow their gas producers to lower prices they charge customers in the United States. The renegotiation period would permit a change in such pricing policies. If the foreign governments continued to insist that their producers charge above-market prices, then their export licenses would be invalidated, and U.S. domestic producers could make up the supply deficit.

When the contract renegotiation period ended, the structure of the natural gas market would have been altered fundamentally. Buyers would be able to contract directly with sellers, and at a price mutually agreed to. For the first time in four decades, the consumer would again be able to exercise his will. The net result of these actions would be lower prices for the end user, and greater incentives for the vast majority of producers.

CONCLUSION

When the Senate first moved to regulate the natural gas market forty-five years ago, it believed it was correcting a market imperfection, and ensuring competition. Were the Solons present in the chamber when the Natural Gas Act was passed able to look into the future and see the actual effect the law would have, they would have been shocked and dismayed. Similarly, the Natural Gas Policy Act has failed to achieve its intended goal. Rather than protecting consumers against high prices, it has fostered them. Rather than simplifying regulations, it has made them more complex. Rather than encouraging a free market in natural gas, it has given rise to even greater market distortions. While these facts may surprise many who labored long, and with good intentions, for passage of the NGPA, they were inevitable. No regulatory regimen can ever duplicate the efficiency of the marketplace.

There is no economic justification for artificially imposed price ceilings. If a commodity is in short supply, controls cause it to be underpriced and overconsumed, leading to its premature exhaustion and discouraging use of substitutes. Shortages, which then create pressure for price increases, must inevitably follow. This is why restoring a free market, and consumer sovereignty to the natural gas market is the only action clearly in the consumer interest.

If the Natural Gas Policy Act is not reformed--or worse, if its provisions are extended--it will be the gas consumer--especially the residential gas consumer--who will suffer. Large gas users often can switch to alternatives. But for homeowners, changing fuels is at best expensive, at worst impossible. Yet, if controls are extended through 1988, the average homeowner will suffer nearly $900 in increased direct costs, and, for a family of four, nearly $3,300 in indirect costs. This is a high and unnecessary price to pay for Congress's unwillingness to confront the natural gas issue. It is a cost that consumers should not have to bear.

Milton R. Copulos
Policy Analyst

STATEMENT OF F. G. TURPIN
PRESIDENT
ALYESKA PIPELINE SERVICE COMPANY
POST OFFICE BOX 4-Z
ANCHORAGE, ALASKA 99509

BEFORE THE
SUBCOMMITTEE ON SURFACE TRANSPORTATION
OF THE HOUSE OF REPRESENTATIVES COMMITTEE
ON PUBLIC WORKS AND TRANSPORTATION

November 9, 1983

Mr. Chairman and Members of the Subcommittee:

My name is Frank G. Turpin. I am President of Alyeska Pipeline Service Company (Alyeska). I have held this position since July of 1978. I am pleased to submit this statement to explain the role of Alyeska as it relates to the operation of the Trans Alaska Pipeline System (TAPS) since I understand TAPS is an important consideration in the pending oil pipeline deregulation proposal, H.R. 2677. At the outset, it is important to understand that the legislative proposal is a matter of policy concern for the eight individual owners (Amerada Hess Pipeline Corporation, ARCO Pipeline Company, BP Pipelines Inc., Exxon Pipeline Company, Mobil Alaska Pipeline Company, Phillips Alaska Pipeline Corporation, Sohio Pipe Line Company, and Union Alaska Pipeline Company) of TAPS but is not a concern of the management of Alyeska.

Alyeska was formed in 1969 to serve two principal roles. During the initial construction, which ended in 1977, it acted as the Contractor for the TAPS Owners in the preparation, planning, design, and construction of the pipeline. Since the completion of the pipeline it has performed the day to day operation of the system for each owner. Initial flow of North Slope oil through TAPS in 1977 was at a nominal rate of 750,000 barrels per day and is currently at a rate of slightly more than 1,600,000 barrels per day.

In order to understand what Alyeska is and does, it may be helpful to start out by reviewing what Alyeska is not and does not do. Alyeska is not a common carrier pipeline company. It does not have a tariff. It does not deal with shippers of crude oil, solicit crude oil for shipment or collect tariff revenues. These functions are performed by each owner acting separately. Alyeska's sole function is to attend to the operation and maintenance of the system.

Each of the eight Owners has an undivided interest in TAPS. In that regard it might be best to think of TAPS not as a single pipeline, but as a bundle of eight separate pipelines. Each of the separate pipeline companies has its own tariff. Alyeska, as a contractor for each of these pipeline companies, notifies each company in advance of its available pipeline space for a given period of time. Each of the pipeline companies is individually responsible for soliciting shippers to fill its pipeline space in TAPS. Each company informs Alyeska of the amount of crude oil it intends to ship in its space for that period and of the identity of the shippers and the volume of each shipper that has tendered crude oil to that pipeline. Alyeska records this information for purposes of accounting for the receipts at Pump Station 1 and deliveries to Valdez. It is important to note, however, that the information provided to us by the carrier, such as ARCO Pipeline Company, is not available to any of the other carriers except as it relates to total volume transported during a given period. Therefore, there is no way for one of these pipeline companies to obtain information as to the specific shippers or clients of the other pipeline companies.

Alyeska maintains records by which it can account for the receipt and delivery of crude oil and actually prepares tickets which are provided to each of the carriers so that each may collect tariff revenues from its shippers. Alyeska does not collect the tariff revenues for the carriers and in fact has no dealings whatsoever with shippers other than to coordinate with the North Slope producers responsible for operating the fields to assure that operations of the system and the field are harmonious.

A copy of the pertinent provisions of the TAPS Operating Agreement setting forth Alyeska's and the Owners' separate responsibilities is included as Attachment "A" to my statement.

Mr. Chairman, I greatly appreciate the opportunity to submit this statement to clarify some of the issues related to the operation of the Trans Alaska Pipeline System. I would be pleased to supply any additional information which the Subcommittee might desire in relation to the activities and responsibilities of Alyeska.

OPERATION

6.1 Rights of Owners. Each Owner, as the holder of an undivided interest in the System, has and retains all the rights of ownership incident to its undivided interest subject only to any applicable laws and regulations, the TAPS Agreement, the Rights-of-Way Agreements and this Operating Agreement. To enable each Owner to exercise its rights, Operator, under the direction and control of the Owners through the Owners Committee, will perform certain duties related solely to the physical operation and maintenance of the System as set out in this Operating Agreement and will act as the Owners common agent to the extent required by the Rights-of-Way Agreements.

6.2 Individual Common Carrier. Each Owner is obligated to conduct the operation of its undivided interest in the System as a common carrier facility and each Owner has agreed that, from and after the Date of Commissioning, its undivided interest in the System will be operated as an individual common carrier facility. In performance of such undertaking, each Owner on its own behalf will in accordance with all applicable laws, regulations and agreements:

(a) separately publish and file tariffs in its own name.

(b) separately solicit and receive tenders of Petroleum from shippers.

(c) separately arrange with its shippers for the transportation of any such tendered Petroleum.

(d) separately collect for its own account and freely dispose of any revenues from its individual and separate operations as a common carrier.

(e) separately arrange for and provide funds required to pay its share of expenses for the operation and maintenance of the System.

(f) separately exercise such other rights and perform such other functions required to operate its undivided interest as an individual common carrier facility.

Neither Operator, nor the Owners Committee, shall have any responsibility for, nor shall they take any action on, matters which relate to common carrier responsibilities as set out in this Section 6.2.

6.3 Owners Committee – Powers and Functions. Each Owner will exercise supervision of the Operator's services through its representative on the Owners Committee. The Owners through the Owners Committee shall:

(a) approve budgets pursuant to Section 11.2 hereof.

(b) approve the acquisition in the name of the individual Owners of Land Rights, materials, supplies and services as required through the budget approval under Section 11.2 hereof.

(c) approve all manuals referred to in this Operating Agreement.

(d) establish standards and procedures for connections to the Pipeline as required by Section 7.8 hereof.

(e) approve settlement of claims, initiation of lawsuits and such other matters as required by Section 9.2 hereof.

(f) approve the disposal of material, equipment and facilities as required by Section 10.2 hereof.

(g) exercise such other authorities and powers as are delegated by the Owners under the terms of this Operating Agreement or as may be required to provide guidelines and policies to permit Operator to perform its services.

6.4 Operator's Services. To enable each Owner to exercise its rights and to effectively discharge its obligations as an individual common carrier, Operator will perform on behalf of each Owner the services related solely to the physical operation and maintenance of the System. As more specifically detailed in this Operating Agreement, Operator shall:

(a) perform such mechanical activities as may be required to transport and otherwise handle Petroleum in each individual Owner's share of System capacity and load on Vessels when and as requested by each Owner consistent with the terms of this Operating Agreement.

(b) submit to Owners recommended budgets, in accordance with Section 11.2 hereof, for their consideration and approval through the Owners Committee.

(c) purchase or cause to be purchased for and in the name of Owners necessary materials, supplies and services and incur such expenses and commitments as required to carry out the operations in accordance with Approved Budgets and within the limitations of this Operating Agreement.

(d) make timely payment of all proper charges, expenses, and liabilities incurred in connection with Approved Budgets and Section 11.3 hereof.

(e) coordinate the acquisition of Land Rights by the Owners as required for the physical operation of the System in accordance with Approved Budgets and Section 6.5 hereof.

(f) act as coordinator of Owners contact with government agencies where required by rules, laws or regulations and/or the Rights-of-Way Agreements relating to the physical operation and maintenance of the System.

(g) dispose of materials, equipment and facilities in accordance with Section 10.2 hereof.

(h) issue only such news items or otherwise engage in public affairs as will be consistent with guidelines issued by the Owners through the Owners Committee relating to the physical operation and maintenance of the facilities within the System.

(i) perform such other activities and take such other action as may be required to carry out the Approved Budgets and other decisions made by the Owners through the Owners Committee, provided such activities or actions relate solely to the physical operation and maintenance of the System.

In performance of its activities pursuant to this Operating Agreement, Operator shall not do any work which would constitute an expansion of the System as that term is used in Article VI of the TAPS Agreement. Operator shall perform all its services under this Operating Agreement in a good and workmanlike manner as a prudent Operator would under the same or similar circumstances. Operator shall conduct all operations and maintenance of the System in accordance with generally accepted practices in the pipeline industry to the end that the System is operated within its design limitations for safe and efficient operations.

6.5 **Acquisition of Land Rights.** All Land Rights shall be acquired by the Owners pursuant to an Approved Budget. It is contemplated, however, that, for convenience, title to some of the Land Rights, such as easements, leases, licenses and permits, may be acquired by and in the name of a Trustee for all of the Owners, in which event the Trustee shall thereafter, as each Owner may individually direct, promptly execute and deliver to all Owners or to one of them as Trustee for all Owners such instruments of transfer, assignment and conveyance as may be appropriate to evidence properly the undivided interest ownership of the particular Owner or Owners. Condemnation may be used by any Owner or Owners to acquire Land Rights whenever the terms and conditions asked for such Land Rights are unreasonable. Each Owner hereby consents to join as a party plaintiff in any condemnation suit filed on conditions hereinafter defined for the purpose of acquiring Land Rights needed for the operation and maintenance of the System and authorizes any attorneys retained in such condemnation suit to join it as a party plaintiff in such suit and to represent it for all purposes in such condemnation proceeding. Each Owner further agrees that it will become qualified to the extent necessary to transact business in the State of Alaska if it is necessary or desirable to do so in order to avoid delay in condemning any such Land Rights. Each Owner shall qualify as promptly as practicable after it is determined that qualification is necessary. All such Land Rights shall be acquired, whenever possible, in assignable form. The cost of all such Land Rights shall be charged to the account of each Owner in accordance with Sections 10 and 11 hereof.

6.6 **Personnel and Other Services.** Operator in performing its duties under this Operating Agreement shall engage the services of independent contractors to perform such parts of the operation and maintenance of the System which cannot be performed by Operator's employees or which can more economically and just as efficiently be performed by independent contractors as with Operator's own employees. Operator shall employ only such personnel as are required to perform its duties under this Operating Agreement and are within staffing limits established by the Owners through the Owners Committee.

○